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Xuan-Thao Nguyen

Southern Methodist University Law School

Jeffrey A. Maine

University of Maine Law School

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ARTICLES

Equity and Efficiency in Intellectual Property Taxation

Xuan-Thao Nguyen[†] and Jeffrey A. Maine[‡]

INTRODUCTION

Intellectual property assets are integral to U.S. businesses.¹ Companies, large and small, expend substantial

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[‡] Professor of Law, University of Maine School of Law. Professor Maine is grateful to his co-author and friend Professor Nguyen for the many collaborations on the intersection of intellectual property and taxation. He would like to thank Professor Jennifer Wiggins for her valuable comments on early drafts and Nathan Brown and Julie Welch for their valuable research assistance.

¹ Consider, for example, Intellectual Ventures, a \$5 billion startup company founded in 2000, which has a patent portfolio of 27,000 patents. *See* Nigel Page, *IV Shifts Gears*, 36 INTELL. ASSET MGMT. 8, 9, 10 (2009), http://www.intellectualventures.com/Libraries/Article_Reprints/IAM_IV_story_July_-_Aug_2009.sflb.ashx (reporting the strategies of acquiring and creating inventions by Intellectual Ventures in the United States and five Asian countries). The company accumulates patents from individuals, companies, and its own laboratory in Bellevue, Washington, in a wide range of fields to serve its numerous purposes, among them, the monetization of intellectual property. *Id.* at 8-17 (discussing Intellectual Ventures's monetization of intellectual property by employing innovative business models). Intellectual Ventures handsomely collects royalties from companies that use any of its patented inventions. *See* Brier Dudley, *Bellevue Lab Is an Inventor's Real Dream*, SEATTLE TIMES (May 27, 2009, 6:01 PM), http://seattletimes.nwsources.com/cgi-bin/PrintStory.pl?document_id=2009266390&zsection_id=2003907475&slug=intvent70&date=20090527. As of 2009, the company had collected \$1 billion in royalties. *Id.* It is now one of the top twenty-five research institutions in the United States and one of the top fifty in the world based on annual patent productivity. *Id.* Intellectual Ventures provides financing to many companies and research universities to continue their invention productivities, and, in

resources creating and developing products and services covered by patents, copyrights, trade secrets, and trademarks.² If businesses lack the expertise, facilities, financing, or time, they license these intellectual property rights from others; segmentation is the business *modus operandi*.³ For tax, employment, and productivity reasons, multinational companies shuffle and migrate their intellectual property assets to favorable state and foreign jurisdictions. Some companies leverage their intellectual property assets for financing, while others leverage for litigation purposes.⁴ Because intellectual property assets are highly valuable, companies seek different forms of intellectual property to protect their products or services, bundling multiple intellectual property rights.⁵

The importance of intellectual property to U.S. business and the economy underscores the need for a sound tax policy governing intellectual property rights. Presently, the Internal Revenue Code contains several special rules governing intellectual property.⁶ Some special tax provisions affect a large group of intellectual property assets;⁷ most, however, cover only

return, Intellectual Ventures gains the ownership of or exclusive rights in patented inventions. *See* Page, *supra*.

² Government statistics reveal the high level of intellectual property development activity in the United States. In 2008, the United States Patent Office received 485,312 patent applications and of those granted 185,224 patents. *U.S. Patent Statistics Chart: Calendar Years 1963-2009*, U.S. PAT. & TRADEMARK OFF. (Apr. 20, 2010, 1:04 PM), http://www.uspto.gov/web/offices/ac/ido/oeip/taf/us_stat.htm (providing statistics of patent applications and grants for each fiscal year). That same year, total trademark filings at the Trademark Office covered 401,392 classes of goods or services and 430,343 disposals, which are “abandonments of applications plus issued registrations.” Trademark Pub. Advisory Comm., *Annual Report*, U.S. PAT. & TRADEMARK OFF. 4 (2008), http://www.uspto.gov/web/offices/com/advisory/reports/tpac_2008annualrpt.pdf. Also during 2008, the Copyright Office received 561,428 copyright claims, of which 232,907 were registered, as well as 526,508 copies of registered and unregistered works valued at \$24 million. *Fiscal Year 2010 Budget Request*, U.S. COPYRIGHT OFF. (Jun. 8, 2009), <http://www.copyright.gov/docs/regstat060409.html>. The Copyright Office recorded more than 330,000 titles of works in fiscal year 2008. *Id.*

³ *See infra* notes 148-49 and accompanying text.

⁴ *See* Xuan-Thao Nguyen & Jeffrey A. Maine, *Acquiring Innovation*, 57 AM. U. L. REV. 775, 791 (2008) [hereinafter Nguyen & Maine, *Acquiring Innovation*] (describing how some companies without “resources, personnel, and facilities to conduct further research and development or to create end products or services” realize their returns on the patent portfolios by finding “potentially deep-pocketed infringers” and forcing them to pay “through litigation and threat of injunction”); Xuan-Thao Nguyen, *Collateralizing Intellectual Property*, 42 GA. L. REV. 1, 16-19 (2007) (explaining how companies leverage intellectual property assets to obtain financing).

⁵ *See infra* Part IV.B.1.

⁶ Unless otherwise noted, all references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended.

⁷ *See, e.g.*, I.R.C. §§ 167(g)(6), 170(e)(1)(B)(iii), 170(m), 197 (2006).

specific types of intellectual property.⁸ While these rules were largely designed to address the shortcomings of traditional taxation principles in the intellectual property context,⁹ ironically, many special tax rules are circumscribed in ways that relegate the tax analysis back to these traditional principles.¹⁰ Thus, the current income tax system governing intellectual property is a mix of special tax rules and general taxation principles.

Ideally, the current intellectual property tax system should embrace the principles of fairness and efficiency. While few would disagree that fairness and efficiency, in the abstract, are important features of any tax policy, disagreement may arise over the applied meaning of these two criteria. The first criterion—tax fairness—is usually described in terms of horizontal equity.¹¹ Horizontal equity requires that persons who are similarly situated should be taxed in a similar fashion.¹² A

⁸ See, e.g., *id.* §§ 41, 167(f)(1), 167(g)(8), 174, 1221(a)(3), 1221(b)(3), 1235, 1253.

⁹ See *infra* notes 185-94 and accompanying text.

¹⁰ See *infra* notes 185-94 and accompanying text.

¹¹ See JOHN A. MILLER & JEFFREY A. MAINE, *THE FUNDAMENTALS OF FEDERAL TAXATION* 4 (2d ed. 2010); see also MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 28 (6th ed. 2009).

¹² See MILLER & MAINE, *supra* note 11, at 4; GRAETZ & SCHENK, *supra* note 11, at 28. Horizontal equity has been compared to the constitutional principle of equal protection under the laws. U.S. CONST. Amend. XIV, § 1; see also Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990); Joseph E. Stiglitz, *Utilitarianism and Horizontal Equity: The Case for Random Taxation*, 18 J. PUB. ECON. 1 (1982).

Some modern theorists question the utility of horizontal equity in tax policy analysis, contending that horizontal equity lacks independent significance and is devoid of any normative content. See, e.g., Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 607 (1993). For the actual debate between Professors Louis Kaplow and Richard Musgrave over the merits of horizontal equity, see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989); Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992) [hereinafter Kaplow, *A Note*] (contending horizontal and vertical equity are aspects of the same principle); Musgrave, *supra*; Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993) [hereinafter Musgrave, *A Further Note*] (arguing horizontal equity has independent significance distinct from vertical equity); see also Anthony C. Infanti, *Tax Equity*, 55 BUFF. L. REV. 1191, 1193-94 (noting criticism of horizontal equity as lacking independent significance); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 89-97 (1996) (summarizing criticisms of horizontal equity).

Critics often point to the difficulty of determining relevant likeness (i.e., the comparison of taxpayers and economic activities). Kaplow, *A Note*, *supra*, at 192-93; McDaniel & Repetti, *supra*, at 612-13. *But see* Musgrave, *A Further Note*, *supra*, at 359; see also Zolt, *supra*, at 95 ("Defining horizontal equity as requiring equal tax treatment for individuals who are, in all relevant aspects, equal accomplishes little. It just begs the question of what is relevant. . . . The principle of horizontal equity does nothing to determine which differences justify different tax treatment."). Requiring equal treatment for equals, they argue, merely begs the question of what equals actually are.

related concept of equity is that economically equivalent activities should be taxed in the same manner even if they differ in form.¹³ Horizontal equity was once considered the primary goal of tax policy,¹⁴ and even if no longer held in quite this same regard, it nonetheless remains an important principle of tax theory.¹⁵

But this objection rests on an “exaggerated view of the level of precision required in order for equality to have meaning.” John A. Miller, *Equal Taxation: A Commentary*, 29 HOFSTRA L. REV. 529, 545 (2000) (“All of our major tax schemes have found ways to determine likeness (or difference) that are generally recognized as fair.”). As one commentator notes, “[H]orizontal equity is concerned with individuals who are ‘similarly situated,’ not with those who are ‘identically situated.’” David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL’Y REV. 43, 44 (2006) (“Tautologically, any conceivable tax arrangement will treat identically situated taxpayers equally. . . . Taxpayers are similarly situated when their situations are considered equivalent.”). Moreover, even if this criticism of horizontal equity is valid, horizontal equity could nevertheless serve as a useful tool to uncover potential problems in a tax system. See Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645, 651 (2006). For example, the tax system’s differential treatment of two intellectual property owners that appear to be in similar economic circumstances might signal a flaw in the intellectual property tax system, or it might at least challenge us to justify disparate treatment.

Some critics also question the use of horizontal equity to analyze tax expenditures (i.e., tax credits and deductions), arguing that a tax expenditure is a subsidy that occurs outside of traditional tax equity analysis. McDaniel & Repetti, *supra*, at 621. In the context of home ownership, Professor Miller has argued that horizontal equity analysis can actually challenge us to justify disparate treatment between homeowners and renters caused by the mortgage interest deduction. Miller, *supra*, at 537-38. Likewise, in the context of intellectual property ownership, horizontal equity analysis can challenge us to justify disparate tax treatment that exists between individual patent and copyright creators and corporations whose employees invent or create.

¹³ See Kahn, *supra* note 12, at 647 (using the term “parallelism” for the proposition that “the same or equivalent receipts, expenditures or losses should be treated the same by the tax law”; non-parallelism “results in disparate tax treatment of taxpayers who occupy similar positions”); Zolt, *supra* note 12, at 49 (using the term “uniform taxation,” which rests on the concept of horizontal equity, “to refer to tax treatment in accordance with some general approach . . . without any differentiation as to type of income or type of taxpayer,” and using the term “nonuniform taxation” to refer “to tax rules that vary by type of income or type of taxpayer”).

¹⁴ See, e.g., RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY* 160 (1959) (“Perhaps the most widely accepted principle of equity in taxation is that people in equal positions should be treated equally.”); HENRY C. SIMONS, *FEDERAL TAX REFORM* 11 (1950) (“Equity in this primary sense must, in an advanced nation, predominate over, if not wholly override, all other objectives.”); see also Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 574-80 (1965).

¹⁵ See, e.g., Miller, *supra* note 12 (discussing the merits of horizontal equity analysis); Elkins, *supra* note 12 (showing independence of horizontal equity as a principle of tax theory); Brian Galle, *Tax Fairness*, 65 WASH. & LEE L. REV. 1323, 1328, 1335-62 (2008) (providing justifications for tax fairness and claiming that horizontal equity “can be defended as an essential feature of the revenue function of taxation” and can operate on principles of its own); Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645 (2003) (arguing equity and efficiency, as opposed to simplicity, are core values); Kahn, *supra* note 12 (recognizing

The second criterion of sound tax policy—efficiency—has been measured by contradictory standards and means various things in various contexts.¹⁶ Ideally, a tax system should be administratively efficient; the costs of administering and complying with intellectual property tax rules should be minimized. Efficiency in tax theory can also be measured in terms of economic growth.¹⁷ Under this standard, the intellectual property tax system would be viewed as efficient if it promoted economic growth¹⁸ and inefficient if it inhibited such growth.¹⁹ Thus, tax subsidies—in the form of deductions, credits, and lower tax rates—for certain intellectual property activities might upset the free market allocations of capital, but

equal treatment of the same items serves the normative goal of fairness, but arguing that parallelism need not necessarily prevail over other legitimate goals).

¹⁶ See MILLER & MAINE, *supra* note 11, at 4; see also GRAETZ & SCHENK, *supra* note 11, at 29-30 (summarizing various meanings of the efficiency criterion).

¹⁷ Alternatively, efficiency can be viewed as a utilitarian concept that seeks a balance between maximizing tax revenues and minimizing the social costs of taxation. See MILLER & MAINE, *supra* note 11, at 4; Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 978-1012 (1986); Herman P. Ayayo, *Tax Expenditures: Useful Economic Concept or Budgetary Dinosaur?*, 93 TAX NOTES 1152 (2001); Zolt, *supra* note 12, at 63 (“Efficient taxes distort as little as possible”; describing three forms in which distortions come). According to this standard, an optimal intellectual property tax system would be neutral—that is, it would not interfere with intellectual property owners’ economic behavior and would avoid deadweight losses caused by restructuring of intellectual property transactions to minimize taxes. GRAETZ & SCHENK, *supra* note 11, at 29 (stating that efficiency requires that a tax interfere as little as possible with people’s economic behavior); Elkins, *supra* note 12, at 47 (stating that efficient taxes minimize deadweight losses caused by taxpayer actions to reduce tax burden by choosing courses of action that minimize tax).

But this standard is of questionable value in the context of intellectual property taxation. Most intellectual property tax rules are deliberately not neutral; thus, under this standard, these rules generate high efficiency costs. Many of the special tax provisions governing patents and copyrights, for example, were a deliberate attempt to support the social-utility mandate of patent and copyright laws. Tax expenditures in the form of deductions and credit for certain research and development, and short write-off periods for certain intellectual property acquisitions, were deliberately designed to drive economic decision-making to achieve more important intellectual property social policies. Whether tax expenditures (i.e., deductions and credits used to influence behavior) represent sound tax policy has been the subject of much debate. See, e.g., Zelinsky, *supra*; Ayayo, *supra*. In any event, at least with respect to the intellectual property tax scheme, neutrality violations are inevitable to achieve more important intellectual property social engineering policies and to advance the public interest.

¹⁸ GRAETZ & SCHENK, *supra* note 11, at 29 (“The efficiency criterion sometimes has other meanings. A tax often is said to be efficient when it promotes economic growth and inefficient when it inhibits such growth.”); Edward Yorio, *The President’s Tax Proposals: A Major Step in the Right Direction*, 53 FORDHAM L. REV. 1255, 1262-63 (1985) (examining economic growth as a principal criterion of sound federal income tax policy).

¹⁹ GRAETZ & SCHENK, *supra* note 11, at 29.

they might be justified because the targeted activities involve significant beneficial externalities.²⁰ And if these subsidies correctly quantify society's interests, according to the economic-growth efficiency standard, they contribute to market efficiency.²¹

The design of any tax system involves tradeoffs between equity and efficiency principles.²² It may be efficient to provide tax breaks to certain innovators because society as a whole benefits from high innovation via encouragement of individual effort through personal gain.²³ But such measures may violate horizontal equity because conflicts between equity and efficiency are often inevitable byproducts. The government must therefore establish reasonable tradeoffs when designing an intellectual property tax system.²⁴ For example, the government might decide to grant equity primacy over efficiency or vice versa.²⁵ If inequity gives way to efficiency, a certain level of inequity might be acceptable; in other words, horizontal equity violations might sometimes be justified but only if the efficiency gains are significant.²⁶

²⁰ Under an economic-growth efficiency standard, the tax system might be said to be efficient even if neutrality violations upset the free market allocations of capital. For example, if policymakers chose to adopt a lower tax on patent owners vis-à-vis copyright owners to stimulate the economy, capital might flow from the copyright segment to the patent segment as a result of the tax change.

²¹ Elkins, *supra* note 12, at 48 ("Where the economic activity concerned produces beneficial externalities, a negative tax (i.e., a subsidy) may be offered. . . . When the subsidy correctly quantifies society's interests, it actually contributes to the efficiency in the market.").

²² See *id.* (arguing efficiency is not necessarily horizontally equitable); Miller, *supra* note 12, at 541 ("Equity and efficiency principles will often coincide."); Zolt, *supra* note 12, at 85 (concluding that "nonuniform tax treatment may yield efficiency gains not available under uniform taxation").

²³ Under the contradictory efficiency standard discussed *supra* note 17, some would argue that such tax breaks to innovators violate the principle of neutrality by encouraging taxpayers to choose patent activities over other intellectual property activities. Under this view, the greater the inequity, the greater the inefficiency.

²⁴ Elkins, *supra* note 12, at 68 ("[E]very tax system must allow some degree of inequality in order to encourage beneficial economic activity."); Zolt, *supra* note 12, at 60-85 (examining choices where unequal treatment yields efficiency gains).

²⁵ See Zolt, *supra* note 12, at 99 (While "efficiency and equity may conflict, [o]ne approach could [be to] grant primacy to equity, regardless of efficiency considerations.").

²⁶ *Id.* at 100 ("If efficiency gains are minor, then there may be strong reasons for not adopting provisions that have inequity, or the perception of inequity. The presumption should be in favor of uniform tax treatment where gains from nonuniform treatment cannot be adequately justified. Where we can demonstrate substantial efficiency gains, rejecting proposals on equity grounds becomes more problematic." (footnote omitted)).

This article evaluates the current U.S. income tax regime governing intellectual property by focusing on the traditional principles of tax policy—tax fairness and efficiency. It highlights the shortcomings of the current tax system in fulfilling both of these tenets. It begins, in Part I, with an overview of intellectual property rights, highlighting substantive similarities and differences among patents, copyrights, and trademarks. Part II turns to the current intellectual property tax system. It evaluates the intellectual property tax scheme in terms of horizontal equity, identifying differences in tax treatment of what appear to be similar intellectual property activities. Part III assesses the efficiency of the intellectual property tax system. Specifically, it examines numerous tax subsidies for intellectual property and their effectiveness in promoting economic growth. It argues that many of these tax expenditures are circumscribed to have limited effectiveness and thus do not optimally contribute to economic growth. It also argues that the current intellectual property tax regime, with varying rules for different types of intellectual property, does not provide necessary certainty and clarity for sound administration and compliance with the law. As an example, the intellectual property tax system is not easily applied to evolving intellectual property rights and trends, such as the bundling of intellectual property rights in actual practice.

Finally, Part IV proffers guidelines for the government in designing a more efficient and equitable tax system for intellectual property. As to the efficiency criterion, a legal framework should establish the proper role, if any, of the tax system in promoting beneficial intellectual property activity.²⁷ While the current tax system aims to promote the innovation goals of patents and patent-like property through various tax expenditures, it arguably hinders beneficial copyright and trademark goals through the absence of adequate tax incentives.²⁸ This article questions this result, viewing most intellectual property rights as achieving similar goals—namely, innovation and/or efficiency policy objectives—and taking a broad view of intellectual property's positive effects on society. As to the equity criterion, a legal framework should establish a basis for rational tax distinctions among intellectual property

²⁷ See *infra* Part IV.A-B.

²⁸ See *infra* notes 211-34 and accompanying text.

forms if distinctions are to be maintained. One solution would be to base tax distinctions not on the legal attributes of intellectual property, which has been the historical approach, but on the intellectual property purposes that intellectual property assets serve. Instead of developing separate tax rules for identified intangibles, creating legal definitions and carving out exceptions, different tax results could be dictated by whether intellectual property is technology-based, marketing-based, or artistic-based—categories the government has adopted for financial reporting purposes.

I. OVERVIEW OF INTELLECTUAL PROPERTY RIGHTS

Before evaluating the intellectual property tax scheme, it is useful to examine the nature of intellectual property rights. In American law, “intellectual property rights often cover . . . patents, copyrights, and trademarks.”²⁹ In contrast to tangible property, which is visible and has physical existence, intellectual property is intangible and has no physical existence.³⁰ Intangible intellectual property rights are separate

²⁹ See generally Nguyen, *supra* note 4, at 6. Computer technology poses challenges to intellectual property doctrines. Copyright law has traditionally served as the source of legal protection for computer programs. See *Williams Elecs., Inc. v. Artic Int'l, Inc.*, 685 F.2d 870, 875 (3d Cir. 1982) (“[T]he copyrightability of computer programs is firmly established after the 1980 amendment to the Copyright Act.”). Copyright law now defines computer software, extends the exclusive rights in a copyright to copyrightable computer software, and imposes limitations on the exclusive rights to allow certain statutorily noninfringing use of the copyrightable computer software. 17 U.S.C. §§ 101, 117 (2006). In addition to copyright law, patent protection has been extended to computer software. See *State St. Bank & Trust Co. v. Signature Fin. Grp., Inc.*, 149 F.3d 1368 (Fed. Cir. 1998).

³⁰ Current tax rules for intangible intellectual property differ substantially from tax rules for tangible property, with intellectual property treated less favorably than tangible property in many instances. For example, the costs of purchasing certain machines and equipment for active use in businesses are immediately deductible, see I.R.C. § 179 (2006) (allowing taxpayers to elect to expense the costs of certain tangible property), but the costs of purchasing intellectual property assets for use in businesses are not and must be capitalized, *id.* § 263(a); Treas. Reg. §§ 1.263(a)-4(b)(1)(i), -4(c)(1) (2004). In addition, the purchase price for a computer can be written off over a period of five years, I.R.C. §§ 167, 168(c), 168(e)(3)(B) (2006), but the purchase price for custom software to run the computer must be written off over either three years or fifteen years, depending on how the software was acquired, *id.* § 167(f) (providing a three-year recovery period for separately acquired computer software); *id.* § 197 (providing a fifteen-year recovery period for software acquired as part of the acquisition of a trade or business). Similarly, a charitable contribution of a building provides the donor with a tax deduction equal to the fair market value of the building, *id.* § 170(a); Treas. Reg. § 1.170A-1(c) (as amended in 2008), whereas a charitable contribution of a patent provides the donor with a deduction equal to the donor's basis, I.R.C. § 170(e)(1)(B)(iii) (2006). In these and other instances, the current tax system treats intellectual property inconsistently with, and less favorably than, tangible property.

from the physical objects containing the intellectual property. Ownership of a book, for example, does not mean ownership of the copyright of the book.

Patents and copyrights are substantively similar in many respects. Patents and copyrights are both intangible personal property.³¹ While neither has a physical form, both are generally dependent on physical forms for their creative existence.³² In addition, both confer similar exclusivity rights. Just as patent owners can exclude others from using, making, selling, or exporting their patented products,³³ copyright owners enjoy the exclusive right to make copies, prepare derivative works, distribute the copyrighted work, and publicly perform and display the work.³⁴ The same clause of the U.S. Constitution empowers Congress to promote the progress of both science and the useful arts.³⁵ In response, Congress has granted significant protections for both patents and copyrights.³⁶

³¹ See 1 J. THOMAS MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 6:4 (4th ed. 2008) (“That there are many common characteristics of patents . . . and copyrights cannot be denied. They all share the attributes of personal property, and are referred to en masse as ‘intellectual property’ or ‘proprietary rights.’”).

³² See Jeanne L. Schroeder, *Unnatural Rights: Hegel and Intellectual Property*, 60 U. MIAMI L. REV. 453, 499-500 (2006) (“[O]bjects of intellectual property have no separate, natural, empirical existence. They ‘exist’ contingently and only insofar as not only their creator, but also other subjects, recognize them as such.”); Dan L. Burk, *Legal and Technical Standards in Digital Rights Management Technology*, 74 FORDHAM L. REV. 537, 538 (2005) (stating intellectual property is generally “embodied in particular physical forms—on paper, on canvas, on magnetic or optical media—that can be guarded from a physical theft”).

³³ See *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388, 392 (2006) (“[T]he Patent Act also declares that ‘patents shall have the attributes of personal property,’ including ‘the right to exclude others from making, using, offering for sale, or selling the invention.’” (citations omitted)).

³⁴ See *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 432-33 (1984) (“Copyright Act grants copyright holder ‘exclusive’ rights to use and to authorize the use of his work in five qualified ways, including reproduction of the copyrighted work in copies.” (citation omitted)).

³⁵ U.S. CONST. art. I, § 8, cls. 1, 8 (“The Congress shall have Power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries . . .”).

³⁶ Congress passed both patent and copyright legislation in 1790 during the first congressional session. Patent Act of 1790, ch. 7, 1 Stat. 109-112 (current version at 35 U.S.C. §§ 1-376 (2006)); Copyright Act of 1790, 1 Stat. 124 (current version at 17 U.S.C. §§ 101-1332 (2006)). The patent statutes went through major revision in 1952. See *Diamond v. Diehr*, 450 U.S. 175, 182 (1981) (noting certain amendments to patent statutes in 1952 and what Congress revised in that year); *Graham v. John Deere Co. of Kansas City*, 383 U.S. 1, 12-17 (1966) (discussing the Patent Act of 1952). Copyright laws witnessed two major revisions: the Copyright Act of 1909 and the Copyright Act of 1976. See Act of March 4, 1909, ch. 320, 35 Stat. 1075; Copyright Act of 1976, Pub. L. No. 94-553, 90 Stat. 2541 (codified at 17 U.S.C. § 101 (2006)); see also *Lotus Dev. Corp.*

Copyrights include the exclusive rights to make copies, prepare derivative works, distribute the works, display the works in public, and perform the works in public.³⁷ Copyright law requires that a work of authorship be original and fixed in a tangible medium of expression.³⁸ Works of authorship cover a wide range of subject matters—for example, movies, video games, software, music, and books;³⁹ originality means that the works must be created independently by the author and must bear some degree of creativity.⁴⁰ The bundle of rights does not last forever, however, as it faces a time limit.⁴¹ This time limitation is consistent with the Founding Fathers' intent in drafting the Patent and Copyright Clause. While the Founding Fathers clearly sought to award authors exclusive rights to their works—based on the belief that a reward-based system would “promote the Progress of Science and useful Arts”⁴²—they also understood that an unfettered right would do little to promote such cultural progress and therefore placed a time

v. Paperback Software Int'l, 740 F. Supp. 37, 47-51 (D. Mass. 1990) (discussing changes and legislative history of copyright statutes).

³⁷ See *N.Y. Times Co. v. Tasini*, 533 U.S. 483, 495 n.4 (2001); see also 17 U.S.C. § 106 (2006) (“Subject to sections 107 through 122, the owner of copyright under this title has the exclusive rights to do and to authorize any of the following: (1) to reproduce the copyrighted work in copies or phonorecords; (2) to prepare derivative works based upon the copyrighted work; (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending; (4) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly; (5) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly; and (6) in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.”).

³⁸ 17 U.S.C. § 102(a) (2006) (“Copyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression . . . from which they can be perceived, reproduced, or otherwise communicated . . .”).

³⁹ *Id.* § 102(a) provides a list of categories for works of authorship: “(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works.”

⁴⁰ See *Feist Publ'ns, Inc. v. Rural Tel. Serv. Co.*, 499 U.S. 340, 358-59 (1991) (stating that “[o]riginality requires only that the author make the selection or arrangement independently . . . and that it display some minimal level of creativity. Presumably, the vast majority of compilations will pass this test, but not all will. There remains a narrow category of works in which the creative spark is utterly lacking or so trivial as to be virtually nonexistent.” (citation omitted)).

⁴¹ See generally *Eldred v. Ashcroft*, 537 U.S. 186 (2003).

⁴² U.S. CONST. art. I, § 8, cl. 8.

limit on the exclusivity for copyrights, the same as they did for patents.⁴³

As with patents, the exclusive rights in copyrights, though limited in time, are granted to encourage the progress of science and the useful arts for the benefit of society.⁴⁴ There is a long-held belief that copyright protection promotes innovation and the “creative activity of authors,”⁴⁵ and induces authors and artists to “release to the public . . . the products of his creative genius.”⁴⁶ Technological advances in the reproduction and distribution of copyrighted works, however, force new changes in copyright law, as Congress continually searches for a balance between copyright protection⁴⁷ and future innovations.

Despite their similarities, there are many substantive differences between patents and copyrights. For example, the legal life of a patent is dictated by the federal patent statute and lasts twenty years from the date of patent application.⁴⁸ The legal life of a copyright under the federal copyright statute is much longer; it spans the life of the original author plus

⁴³ *Id.*

⁴⁴ See *Mazer v. Stein*, 347 U.S. 201, 219 (1954) (“The economic philosophy behind the clause empowering Congress to grant patents and copyrights is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors and inventors in ‘Science and useful Arts.’”); *United States v. Paramount Pictures, Inc.*, 334 U.S. 131, 158 (1948) (“The copyright law, like the patent statutes, makes reward to the owner a secondary consideration. . . . It is said that reward to the author or artist serves to induce release to the public of the products of his creative genius.”).

⁴⁵ *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 429 (1984) (explaining that “[t]he monopoly privileges that Congress may authorize are neither unlimited nor primarily designed to provide a special private benefit. Rather, the limited grant is a means by which an important public purpose may be achieved. It is intended to motivate the creative activity of authors and inventors by the provision of a special reward”). But see Stewart E. Sterk, *Rhetoric and Reality in Copyright Law*, 94 MICH. L. REV. 1197, 1205, 1209, 1213-15 (1996) (arguing that “demonstrating how neither the need to generate creative activity nor the desire to reward deserving authors provides a plausible justification for current copyright doctrine”).

⁴⁶ *Paramount Pictures*, 334 U.S. at 158; see also Stephen Breyer, *The Uneasy Case for Copyright: A Study of Copyright in Books, Photocopies, and Computer Programs*, 84 HARV. L. REV. 281, 288-89 (1970) (examining the “property” right in copyrights and asserting that “property rights are often created for reasons of efficiency” rather than “solely on the basis of labor expended”).

⁴⁷ See *Eldred v. Ashcroft*, 537 U.S. 186, 222 (2003) (“[T]he Copyright Clause empowers Congress to determine the intellectual property regimes that, overall, in that body’s judgment, will serve the ends of the Clause. . . . Congress may ‘implement the stated purpose of the Framers by selecting the policy which in its judgment best effectuates the constitutional aim.’” (quoting *Graham v. John Deere Co. of Kansas City*, 383 U.S. 1, 6 (1966))).

⁴⁸ 35 U.S.C. § 154(a)(2) (2006) (providing that the patent term is twenty years from an effective filing date).

reputation-related rewards associated with a desirable product.”⁵⁶

II. EVALUATING EQUITY IN THE INTELLECTUAL PROPERTY TAX SYSTEM

Having introduced the characteristics of intellectual property rights, we turn to the current tax system governing those rights. Ideally, the income tax regime for intellectual property transactions should embrace the principle of fairness.⁵⁷ Unfortunately, it is difficult to evaluate a tax system governing intangible rights from an equity perspective because these rights involve such a broad range of economic activities that no two taxpayers will be situated exactly equally. For example, should a person selling a literary copyright and a person selling a musical copyright be treated as equals for tax purposes? Should a seller of computer software protected as a patent be viewed as similarly situated to a seller of similar computer software that is protected as a trade secret? Should a purchaser of a domain name functioning as a trademark be considered equal to a purchaser of a generic domain name? Is a person who donates intellectual property to a large university engaged in applied research similar to a person who donates similar intellectual property to a small college engaged in fundamental, purely scientific research?

⁵⁶ *Qualitex Co. v. Jacobson Prods. Co.*, 514 U.S. 159, 163-64 (1995). As explained by the Court in *Qualitex*,

In principle, trademark law, by preventing others from copying a source-identifying mark, “reduce[s] the customer’s costs of shopping and making purchasing decisions,” for it quickly and easily assures a potential customer that *this* item—the item with this mark—is made by the same producer as other similarly marked items that he or she liked (or disliked) in the past. At the same time, the law helps assure a producer that it (and not an imitating competitor) will reap the financial, reputation-related rewards associated with a desirable product. The law thereby “encourage[s] the production of quality products,” and simultaneously discourages those who hope to sell inferior products by capitalizing on a consumer’s inability quickly to evaluate the quality of an item offered for sale.

Id. (internal citations omitted); see also Mark Bartholomew, *Advertising and the Transformation of Trademark Law*, 38 N.M. L. REV. 1, 1 (2008) (stating that trademark law promotes efficiency as consumers reduce their research cost by relying on brand names); Mark P. McKenna, *The Normative Foundations of Trademark Law*, 82 NOTRE DAME L. REV. 1839, 1841-43, 1848 (2007) (critiquing the law and economic approach to trademark law which emphasizes economic efficiency of trademark law purposes).

⁵⁷ See *supra* notes 11-15 and accompanying text.

Viewing all intellectual property owners as equals and treating them equally for tax purposes would have unarguable appeal. Consider the general tax treatment of both patents and copyrights. The legal protections granted to patents and copyrights are very similar in substance—both essentially functioning as grants of monopolies.⁵⁸ If the intellectual property system treats patents and copyrights similarly, the tax rules designed to support the system might also treat them similarly—an approach that seems consistent with tax notions of fairness.⁵⁹

A fundamental problem with the current intellectual property tax system, however, is inconsistency. Patent and copyright owners are treated equally in some tax contexts but unequally in others. For example, the acquisition costs of patents and copyrights are treated similarly for tax purposes,⁶⁰ as are patent and copyright donations.⁶¹ But the taxation of development costs differs between patents and copyrights. Patent development costs are deductible when incurred,⁶² whereas most copyright creation costs must be capitalized.⁶³ Likewise, sales of self-developed patents are generally entitled to preferential capital-gains treatment,⁶⁴ while sales of most self-created copyrights are generally not.⁶⁵

⁵⁸ See *supra* text accompanying notes 31-47.

⁵⁹ See *supra* text accompanying notes 11-15.

⁶⁰ See I.R.C. §§ 197(a), (e)(4)(C) (2006) (providing a fifteen-year amortization period for patents and copyrights acquired in a transaction involving the acquisition of assets constituting a trade or business); see also *id.* § 167; Treas. Reg. §§ 1.167(a)-3 (as amended in 2004), 1.167(a)-14 (as amended in 2006) (providing alternative depreciation rules for patents and copyrights acquired separately).

⁶¹ See I.R.C. §§ 170(a), (e)(1)(B)(iii) (2006) (limiting initial charitable contribution tax deduction to adjusted basis in donated patents and copyrights).

⁶² See *id.* § 174(a) (allowing taxpayers to “treat research or experimental expenditures which are paid or incurred . . . during the taxable year in connection with . . . trade or business as expenses which are not chargeable to capital account”); *id.* § 263(a)(1)(B) (providing that the capitalization rules under section 263(a) do not apply to “research and experimental expenditures deductible under section 174[a]”).

⁶³ See *id.* § 263(a); Treas. Reg. § 1.263(a)-4(b)(1)(iii), -4(b)(3), -4(d)(5) (2004) (requiring capitalization of costs of obtaining rights from a governmental agency, as well as costs of creating any “separate and distinct intangible asset”); see also I.R.C. § 263A(a)-(b) (2006) (requiring capitalization of all direct and indirect expenditures incurred to produce creative properties, such as films, sound recordings, video tapes, books, and similar properties that embody the words, ideas, concepts, images, or sounds by the creators thereof). But see *id.* § 263A(h) (providing an exception from the capitalization requirement, permitting certain freelance writers, photographers, and artists to deduct any “qualified creative expense” that would otherwise be capitalized).

⁶⁴ See I.R.C. § 1235 (2006) (providing statutory assurance to certain individual inventors that the sale of their patents will qualify for reduced capital-gains rates).

⁶⁵ See *id.* §§ 1221(a)(3) (excluding from the definition of capital asset a literary, musical, or artistic composition, or similar property held by the creator),

To be sure, there are distinctions between patents and copyrights.⁶⁶ But even if patent owners are different from copyright owners, based on tax equity principles, two patent owners that are similarly situated, or two copyright owners whose situations are similar, should be taxed in a similar fashion. Under the current intellectual property tax regime, however, this is not the case, raising serious equity concerns.⁶⁷

A. *Inequities in the Tax Treatment of Intellectual Property Development Costs*

Since the inception of the modern federal income tax system, the Internal Revenue Code (the “Code”) has precluded a current deduction for so-called “capital expenditures,” historically defined as any expenditure that produces an asset lasting beyond the current tax period.⁶⁸ With respect to intellectual property development expenditures, though, Congress has specifically legislated specific exceptions to asset capitalization,⁶⁹ and the Internal Revenue Service (the “IRS”) has administratively created additional exceptions.⁷⁰ These legislative and administrative exceptions to normative capitalization have inequitable results. The following example is illustrative.

1231(b)(1)(C). *But see id.* § 1221(b)(3) (providing an exception for sales of musical compositions and copyrights in musical works).

⁶⁶ See *supra* text accompanying notes 48-50.

⁶⁷ Many of the inequities identified here in the tax treatment of intellectual property do not exist in the tax treatment of tangible real or personal property.

⁶⁸ Revenue Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167 (providing “[t]hat no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property”). For the current disallowance provisions, see I.R.C. §§ 263, 263A (2006). The reason capitalized expenditures are not currently deductible is that the property created or acquired is not consumed or used up within the year, but rather continues to contribute to income over a period of years. If the costs incurred in the creation or acquisition of such property were deductible in full in the current year, there would be a mismatch of income to expenses that produced that income; income would be understated in the year of creation or acquisition and overstated in later years. By prohibiting the immediate deduction of capital expenditures, this problem is avoided.

⁶⁹ See I.R.C. §§ 174 (allowing a deduction for research and experimental expenditures that would otherwise be capitalized), 263A(h) (allowing a deduction for qualified creative expenses incurred by freelance authors, writers, and photographers that would otherwise be capitalized) (2006).

⁷⁰ See Treas. Reg. §§ 1.263(a)-4(b)(1)(iii), -4(b)(3)(v) (2004) (allowing a deduction for graphic and package design costs even though long-term trademark and copyright protections are obtained on such designs); Rev. Proc. 69-21, 1969-2 C.B. 303, *updated by* Rev. Proc. 2000-50, 2000-2 C.B. 601, *modified and superseded by* Rev. Proc. 2007-16, 2007-1 C.B. 358 (allowing a current deduction for software development costs regardless of method length of intellectual property protection).

Consider two novice inventors, Inventor A and Inventor B. Each spends \$100,000 to develop her first patented invention. Inventor A plans to enter a future business of her own with her developed technology, marketing the technology herself. Inventor B, however, plans to license his developed technology to a company that will market the developed technology to its customers. Inventor A and Inventor B appear similarly situated; each spends \$100,000, and each obtains patent protections for similar technologies that will be exploited in the commercial marketplace. Nevertheless, under the present tax system, Inventor A and Inventor B are not treated equally. Inventor A may currently deduct \$100,000 in research costs, but Inventor B may not. This disparate treatment stems from Section 174⁷¹ of the Code, which allows a current deduction only for research expenditures incurred “in connection with” the inventor’s trade or business.⁷² While a taxpayer need not be currently conducting a business (i.e., producing or selling any product) for research or experimental expenditures to meet Section 174’s “in connection with a trade or business” requirement,⁷³ courts have required that a taxpayer show a realistic prospect of entering into a trade or business in the future that will exploit the technology under development.⁷⁴ To do so, the taxpayer must demonstrate both an objective intent to enter into the trade or business, and the ability to perform the business.⁷⁵

⁷¹ I.R.C. § 174(a) (2006).

⁷² *Id.*

⁷³ Prior to 1974, the IRS and the courts took the position that to qualify for Section 174 treatment, a taxpayer must already have engaged in a trade or business. *See Best Universal Lock Co. v. Comm’r*, 45 T.C. 1 (1965), *acq.*, 1966-2 C.B. 4 (1966); *Koons v. Comm’r*, 35 T.C. 1092, 1098, 1100 (1961). The U.S. Supreme Court rejected this narrow approach and held that pre-operational research or experimental expenditures could qualify for the Section 174 deduction. *Snow v. Comm’r*, 416 U.S. 500, 503-04 (1974).

⁷⁴ *Kantor v. Comm’r*, 998 F.2d 1514, 1518 (9th Cir. 1993) (“[T]he taxpayer must demonstrate a ‘realistic prospect’ of subsequently entering its own business in connection with the fruits of the research, assuming that the research is successful.”); *see also Zink v. United States*, 929 F.2d 1015, 1023 (5th Cir. 1991); *Spellman v. Comm’r*, 845 F.2d 148, 149-50 (7th Cir. 1988); *Stauber v. Comm’r*, 63 T.C.M. (CCH) 2258 (1992); *Diamond v. Comm’r*, 92 T.C. 423, 439 (1989), *aff’d*, 930 F.2d 372 (4th Cir. 1991).

⁷⁵ *See Kantor*, 998 F.2d at 1518-19 (holding that the partnership possessed neither “the objective intent nor the capacity of entering such a business” at the time it incurred research expenditures); *Diamond*, 930 F.2d at 375 (“The question is not whether it is possible in principle, or by further contract, for [the taxpayer] to engage in a trade or business, but whether, in reality, the [taxpayer] possessed the capability in the years before the court to enter into a new trade or business in connection with the [products being developed].”); *Glassley v. Comm’r*, 71 T.C.M. (CCH) 2898 (1996).

As a general rule, the receipt of royalties alone does not constitute a trade or business.⁷⁶ In one recent case, the Ninth Circuit affirmed a Tax Court decision that denied current deductions to a computer software developer who did not market the developed technology himself, but instead licensed the technology to another company for use in that company's trade or business.⁷⁷ The court concluded that mere licensing of the developed technology did not meet the requisite trade or business standard in the statute. A few Tax Court decisions have held that research activities, and exploitation of the resulting inventions by sale or license, may constitute a trade or business.⁷⁸ But these cases involved inventors who had developed a series of inventions.⁷⁹ Thus, in practice, Section 174 fails to recognize the important role of technology licensing and favors only inventive activities of a sufficiently sustained character.

As with patent development activity, not all economically equivalent copyright creation activities are treated equally for tax purposes. As crafted, the legislative and administrative exceptions to the asset-capitalization rule produce different tax results depending on the status of the copyright creator—as an individual versus a corporation—and, in some cases, on the nature of the property embodying the copyright.⁸⁰ In general, costs incurred in creating works that are subject to copyright protection are not currently

(denying Section 174 deductions for expenditures to develop jojoba plants and seeds because taxpayer had neither intent nor capability to enter jojoba farming business).

⁷⁶ See H.R. REP. NO. 97-201, at 113 (1981) (laying out rules for the application of Section 174, but not explicitly naming licensing as a trade or business that entitles taxpayers to relief under that provision).

⁷⁷ *Saykally v. Comm'r*, 85 T.C.M. (CCH) 1401 (2003), *aff'd*, 247 F. App'x 914 (9th Cir. 2007).

⁷⁸ See *Kilroy v. Comm'r*, 41 T.C.M. (CCH) 292, 295 (1980) (permitting deductions where actions, over a period of years, relating to inventing activities suggested taxpayers were engaged in the trade or business of inventing); *Louw v. Comm'r*, 30 T.C.M. (CCH) 1421, 1422-23 (1971) (permitting deductions since taxpayer's freelance inventive activities were of sufficiently sustained character to qualify as engaging in a trade or business of an inventor); *Avery v. Comm'r*, 47 B.T.A. 538, 542 (1942) (permitting business deductions where taxpayer "held the patents [to his inventions] for sale or license to others for profit").

⁷⁹ See *Kilroy*, 41 T.C.M. (CCH) at 295 ("numerous patents"); *Avery*, 47 B.T.A. at 540 ("about a dozen patents"). But see *Cleveland v. Comm'r*, 297 F.2d 169, 173 (4th Cir. 1961) (deeming a single invention held by a joint venture to be sufficient).

⁸⁰ The nature of the copyright creator (individual versus entity) can produce different tax results. See *infra* notes 81-82 and accompanying text. The nature of the property embodying the copyright can also produce different tax results. See *supra* notes 83-86 and accompanying text.

deductible,⁸¹ but Congress has carved out a narrow exception for certain costs incurred by individual writers, photographers, and artists when engaged in their respective trades.⁸² As a result, expenses incurred by an individual author in writing a book are currently deductible, but similar creative costs incurred by a book publishing company (costs of writing, editing, and designing) must be capitalized.

Although corporate taxpayers must generally capitalize copyright creation costs, capitalization is not required if the subject of copyright protection is computer software⁸³ or certain advertising materials.⁸⁴ As a result, a corporation may not deduct the costs of developing copyrighted books, films, or songs, but it may deduct the costs of developing copyrighted software, graphic designs, and package designs used in advertising. Ironically, the value produced in each case lies not in the different tangibles embodying the copyright, but in the

⁸¹ Section 174 does not apply to copyright creation expenses because such expenses do not constitute "research and experimental expenditures" within the meaning of Section 174. *See* Treas. Reg. § 1.174-2(a)(1)-(2) (as amended in 1994). Section 162 generally does not apply to copyright creation costs as the Code requires such costs to be capitalized. *See* I.R.C. § 263(a) (2006); Treas. Reg. § 1.263(a)-4 (2004) (requiring capitalization of costs of obtaining rights from a governmental agency, as well as costs of creating any "separate and distinct intangible asset"); *see also* I.R.C. § 263A(a)-(b) (2006) (requiring capitalization of all direct and indirect expenditures incurred to produce creative properties, such as films, sound recordings, video tapes, books, and similar properties that embody the words, ideas, concepts, images, or sounds by the creators thereof).

⁸² I.R.C. § 263A(h) (2006) (providing an exception from the capitalization requirement, permitting certain freelance writers, photographers, and artists to deduct "qualified creative expenses" that would otherwise have to be capitalized).

⁸³ Under a longstanding administrative ruling, software development costs are treated the same (i.e., currently deductible) regardless of whether the software is protected by patent, copyright, or trade secret. *See* Rev. Proc. 69-21, 1969-2 C.B. 303, *updated by* Rev. Proc. 2000-50, 2000-2 C.B. 601, *modified and superseded by* Rev. Proc. 2007-16, 2007-1 C.B. 358.

⁸⁴ As a general rule, the government allows taxpayers to currently deduct advertising costs notwithstanding the fact that advertising often produces benefits that continue well beyond the current taxable year. *See* Rev. Rul. 92-80, 1992-2 C.B. 57. Only in unusual circumstances must the costs be capitalized, such as where advertising is directed toward obtaining future benefits significantly beyond those traditionally associated with ordinary product, institutional, or goodwill advertising. *Id.* Advertising expenditures often encompass the costs of creating materials that are copyrighted. An interesting question is whether the long-term intangible benefits provided by copyright protection should serve as the basis for requiring capitalization of advertising campaign expenditures. Or, should such costs be deductible because they resulted from "advertising" activities? In one case, the Tax Court allowed trade dress and copyright development costs to be deducted, even though such costs in a non-advertising context most likely would have to be capitalized. *R.J.R. Nabisco Inc. v. Comm'r*, 76 T.C.M. (CCH) 71 (1998).

intangible copyright protections themselves.⁸⁶ Even if the copyright protections are identical in each case, the tax consequences to the corporate creators differ significantly.⁸⁶

B. *Inequities in the Tax Treatment of Intellectual Property Acquisition Costs*

Inequities in the tax treatment of intellectual property acquisition costs are also prevalent. Under the current tax system, the costs of acquiring intellectual property must first be capitalized⁸⁷ and then are subject to a host of irrational tax depreciation rules.⁸⁸ The methods⁸⁹ and periods⁹⁰ for recovering

⁸⁶ Holders of copyrights enjoy the exclusive rights to reproduce, distribute, display, perform, and prepare derivatives of the works of authorship. That means holders of copyrights have more rights than mere ownership of the physical copy of the works of authorship. Michael J. Madison, *Notes on a Geography of Knowledge*, 77 *FORDHAM L. REV.* 2039, 2071 (2009) (“[T]he physical ‘copy’ is excluded from the scope of copyright and the intangible ‘work’ or ‘work of authorship’ is regarded as the fruit of the author’s creative labors. The authority of the copyright itself, therefore, inheres in something other than the material form of the product. . . . A copyright in a novel covers the full text of the book, but it may also extend separately to its plot or even to a particular character.”); Gary Pulsinelli, *Harry Potter and the (Re)Order of the Artists: Are We Muggles or Goblins?*, 87 *OR. L. REV.* 1101, 1107 (2008) (“Copyright law is concerned only with rights in the *artistic* design of an object, not with the right to the *physical possession* of a tangible object embodying that design.”); Ned Snow, *Copytraps*, 84 *IND. L.J.* 285, 296 (2009) (noting that copyright holders exercise their reproduction and distribution rights under copyright law when they sell physical copies of their copyrighted works to consumers).

⁸⁶ For a discussion of copyright protections, see *supra* notes 31-47 and accompanying text.

⁸⁷ I.R.C. § 263 (2006); Treas. Reg. §§ 1.263(a)-4(b)(1)(i), -4(c)(1) (2004) (“A taxpayer must capitalize amounts paid to another party to acquire any intangible [property] from that party in a purchase or similar transaction.”).

⁸⁸ In an economic sense, depreciation is the decline in value of an asset due to wear and tear and obsolescence. For tax purposes, depreciation is a deduction from income, permitting the taxpayer to recover the capitalized cost of that asset. Depreciation methods are sometimes called cost recovery systems. So, for example, if an asset used in business for five years costs a taxpayer \$5000, the taxpayer might take a \$1000 deduction each year on her taxes for five years to reflect the decline in value of that asset and to reflect its contribution to the production of taxable income. The entire cost of the asset is not deducted all at once because the asset helped produce income over five years. To match the taxpayer’s expenses against the revenues they helped produce, the taxpayer must spread out the deduction over the useful life of the asset. See generally MILLER & MAINE, *supra* note 11, at 118-22.

⁸⁹ Capitalized intellectual property costs are depreciated using either the straight-line method or the income-forecast method depending on a number of factors. See I.R.C. §§ 197(a), (e)(3)-(4) (2006) (requiring straight-line method for intellectual property acquired in connection with the acquisition of assets that constitute a trade or business); see also *id.* §§ 167(a), (g)(8); Treas. Reg. §§ 1.167(a)-3 (as amended in 2004), -14 (as amended in 2006), (b)-1 (as amended in 1960) (allowing either the straight-line method or the income-forecast method for intellectual property acquired separately). Accelerated or “bonus” depreciation methods that are available for depreciable tangible property are not available for intangible property. See I.R.C. § 168(b) (2006). But see I.R.C. §§ 197(e)(3),

capitalized intellectual property acquisition costs vary by the type of intellectual property acquired,⁹¹ the manner of procurement,⁹² and even the method of payment.⁹³ Prescribed recovery periods, for example, range from three to fifteen years,

179(a), (d)(1)(A)(ii) (2006) (permitting taxpayers to elect to deduct the cost of purchasing off-the-shelf computer software).

Under the straight-line method, acquisition costs are deducted ratably over the asset's useful life or over a statutorily prescribed recovery period. Under the income-forecast method, acquisition costs are recovered as income is earned from exploitation of the patent. Rev. Rul. 60-358, 1960-2 C.B. 68, *supplemented by* Rev. Rul. 64-273, 1964-2 C.B. 62, *supplemented by* Rev. Rul. 79-285, 1979-2 C.B. 91. The depreciation allowance in any given year is computed by multiplying the original acquisition cost by a fraction, the numerator of which is income from the intellectual property for the taxable year and the denominator of which is forecasted or estimated total income to be earned in connection with the intellectual property during its useful life. *Id.* Consider the following example. In Year 1, Taxpayer purchases a patent for \$100 and estimates that forecasted total income from the patent will be \$200. In Year 1, the patent generates income of \$80. The depreciation allowance for Year 1 is \$40, computed by multiplying the acquisition cost of \$100 by the fraction obtained by dividing current year income of \$80 by forecasted total income of \$200. Under this approach, 40% of forecasted income was earned in Year 1, so 40% of the total purchase cost was deducted in Year 1. *See* Prop. Treas. Reg. § 1.167(n)-4(b).

⁹⁰ Some types of intellectual property are depreciated over an arbitrary fifteen-year period regardless of the intellectual property's legal or useful life. *See* I.R.C. §§ 197(a)-(b), (d)(1)(C)(iii), (d)(1)(F) (2006). Other types are depreciated ratably over their useful life (i.e., under the straight-line method). *Id.* §§ 167(a), 197(e)(3)-(4); Treas. Reg. §§ 1.167(a)-3 (as amended in 2004), (a)-14 (as amended in 2006), (b)-1 (as amended in 1960). Others are depreciated only as the intellectual property generates income (i.e., under the income-forecast method). I.R.C. § 167(g)(8) (2006); Treas. Reg. § 1.167(a)-14 (as amended in 2006). As with the appropriate depreciation method, the appropriate recovery period depends on a number of factors.

⁹¹ For example, trademarks, trade names, trade secrets, and know-how are depreciated over fifteen years. I.R.C. §§ 197(a)-(b), (d)(1)(C)(iii), (d)(1)(F) (2006). Patents and copyrights acquired separately are depreciated over their useful lives under either the straight-line method or income-forecast method. *Id.* §§ 167(a), (g)(8); Treas. Reg. §§ 1.167(a)-3 (as amended in 2004), -14(a) (as amended in 2008). Computer software acquired separately is generally depreciated over three years. I.R.C. § 167(f) (2006).

⁹² Intellectual property may be acquired in a transaction involving the acquisition of a trade or business or may be acquired separately or with a group of assets that collectively do not constitute a trade or business. For many types of intellectual property, such as patents, patent applications, and computer software, depreciation rules differ depending on the method of procurement (i.e., Section 197 applies only if these assets are acquired with a business). *See* I.R.C. § 197(e)(3)-(4) (2006). For other types, such as trademarks, trade names, trade secrets and know-how, method of procurement is irrelevant (i.e., Section 197 applies regardless of whether these assets are acquired separately or with a business). *See id.*

⁹³ As consideration, intellectual property transferees may make up-front principal payments, installment payments of a fixed amount, payments contingent on exploitation of the intellectual property, or use any combination of these methods. When contingent payments are made, depreciation rules differ depending on whether the intellectual property is acquired separately or acquired with a trade or business. For example, if a contingent payment is made for a patent acquired with a business, the contingent amount is written off over a fifteen-year period. Treas. Reg. § 1.197-2(f)(2)(i) (as amended in 2008). If a contingent payment is made for a patent acquired separately, then the contingent amount is fully deductible in the year paid. *Id.* § 1.167(a)-14(c)(4) (as amended in 2006).

depending on the type of intellectual property acquired and the manner of procurement: fifteen years for all acquired trade secrets, trademarks, and trade names;⁹⁴ fifteen years for patents, copyrights, and computer software acquired with a trade or business;⁹⁵ five years for separately acquired musical copyrights;⁹⁶ and three years for separately acquired computer software.⁹⁷ A fixed recovery period is not prescribed for patents and copyrights acquired separately. Instead, the capitalized costs of these assets are recovered under one of two approaches: (1) over their estimated useful lives under the “straight-line method” or (2) as income is actually earned under the “income-forecast method” (which has a maximum write-off period of eleven years).⁹⁸

The consequences of this approach raise policy concerns regarding depreciation. For example, a patent acquired as part of a business acquisition is subject to ratable fifteen-year amortization (which may be shorter or longer than the actual useful life of the patent), but a patent acquired separately benefits from more rapid depreciation allowances (shorter useful life under the straight-line method or accelerated allowances under the income-forecast method).⁹⁹ Is it logical that all patents—regardless of type or remaining legal life—acquired along with a business are grouped into a single category with a single recovery method and period, while patents acquired separately are depreciated using an asset-by-

⁹⁴ I.R.C. §§ 197(a), (d)(1)(F) (2006); Treas. Reg. § 1.197-2(b)(5) (as amended in 2008).

⁹⁵ I.R.C. §§ 197(a), (d)(1)(C)(iii) (2006); Treas. Reg. § 1.197-2(b)(5) (as amended in 2008).

⁹⁶ I.R.C. § 167(g)(8)(A) (2006), *amended by* Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222 (providing that a taxpayer may elect to ratably deduct the costs of acquiring any musical composition or any copyright with respect to musical composition property over a five-year period instead of using the income forecast method).

⁹⁷ I.R.C. § 167(f).

⁹⁸ For patents and copyrights acquired outside the context of a business acquisition, tax depreciation rules that were applicable prior to 1993 generally continue to apply. Treas. Reg. §§ 1.167(a)-3(a) (as amended in 2004), -14(e) (as amended in 2006). In 1997, Congress codified the income-forecast method of depreciation in Section 167(g) of the Code, providing a maximum recovery period of eleven years for income forecast property. I.R.C. § 167(g) (2006), *amended by* Small Business Job Protection Act of 1996, Pub. L. No. 104-188; *see also* H.R. REP. NO. 105-148, at 514, *reprinted in* 1997 U.S.C.C.A.N. 908. Forecasted total income includes all income the taxpayer reasonably believes will be earned during the eleven-year period beginning with the year the property is placed in service. I.R.C. §§ 167(g)(1)(A), (g)(5)(C) (2006). In the eleventh year, a taxpayer may deduct any unrecovered costs left in the property. *Id.* § 167(g)(1)(C).

⁹⁹ *See supra* notes 94-98 and accompanying text.

asset approach? If patents derived their value from their relationship to a product, service, or goodwill of a business, as do trademarks or trade names, it might be justifiable to provide an arbitrary recovery period to avoid messy valuation and intangible asset allocation problems. However, the value of a patent acquired as part of the purchase of a trade or business is not necessarily tied to the goodwill of the acquired trade or business.¹⁰⁰ Rather, patents can be freely sold, assigned, or transferred without associated goodwill or other business assets.¹⁰¹ The same is true of copyrights and computer-software (which is subject to different intellectual property protections).¹⁰²

As a result, the depreciation schedule for patents, copyrights, and software need not necessarily parallel the arbitrary depreciation schedule applicable to intangibles acquired in a business acquisition, which lack inherent value (such as trademarks and trade names). Indeed, an argument could be made that, if two patents or two copyrights or two types of computer software are capable of reasonable valuation, and have relatively similar commercial lives, they should be subject to similar tax rules no matter how acquired.¹⁰³

¹⁰⁰ Trademarks, in part, derive their value from goodwill. See 1 MCCARTHY, *supra* note 31, §§ 2:18-19 (citing *Mut. Life Ins. Co. v. Menin*, 115 F.2d 975 (2d Cir. 1940)). The value of patents, however, stems from the owner's ability to "exclude others from making, using, selling, or offering for sale the invention within the United States" for a set number of years. 5 DONALD S. CHISUM, CHISUM ON PATENTS § 16.01 (2010).

¹⁰¹ 35 U.S.C. § 261 (2006) ("Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States."); see also *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 135-36 (1969) (citing *Waterman v. Mackenzie*, 138 U.S. 252, 255 (1891)) ("The law . . . recognizes that [the patent holder] may assign to another his patent, in whole or in part, and may license others to practice his invention.").

¹⁰² A copyright can be transferred separately. See 17 U.S.C. § 201(d) (stating that "[t]he ownership of a copyright may be transferred in whole or in part by any means of conveyance or by operation of law" and that "[a]ny of the exclusive rights comprised in a copyright . . . may be transferred . . . and owned separately"). Trademarks, in contrast, are accompanied by the business goodwill they represent. See Susan M. Richey, *The Second Kind of Sin: Making the Case for a Duty to Disclose Facts Related to Genericism and Functionality in the Trademark Office*, 67 WASH. & LEE L. REV. 137, 167 n.146 (2010) ("The Lanham Act prohibits assignments in gross, requiring that purchase of a trademark be accompanied by the business goodwill that it represents, and, in the event that a transfer violates the rule, the assignment is void.").

¹⁰³ Tax inequities with respect to software purchases are even more evident in light of the artificially short recovery period for separately acquired software. While software acquired as part of the acquisition of a business is depreciated over fifteen years, software acquired separately is depreciated over three years—a substantial tax benefit to those taxpayers who can navigate the system and negotiate for separate

Another example of tax inequity under depreciation rules for intellectual property acquisitions relates to the treatment of contingent payments. Contingent payments made for patents and copyrights *acquired with a business* are treated differently from contingent payments made for patents and copyrights *acquired separately*. If a contingent payment is made for a patent acquired with a business, the contingent amount is written off over a fifteen-year period.¹⁰⁴ If, on the other hand, a contingent payment is made for a patent acquired separately, the contingent amount is fully deductible in the year paid.¹⁰⁵ The apparent rationale behind permitting this immediate deduction for separately acquired patents is that each payment reflects the annual cost of the patent and that a current deduction properly matches expenses with income.¹⁰⁶ However, the same policy can support current deductions for all contingent payments, regardless of whether the patent is acquired separately or with a trade or business. Any concerns about valuing intangibles acquired in a business acquisition or about allocating the purchase price among acquired intangibles should be nonexistent when contingent payments are involved.

purchases of software. Compare I.R.C. §§ 197(a)-(b), (e)(3) (2006) (providing fifteen-year recovery period) with *id.* § 167(f)(1) (providing three-year recovery period).

¹⁰⁴ Treas. Reg. § 1.197-2(f)(2)(i) (as amended in 2008). According to the legislative history:

[I]f a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible is to be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is to be amortized ratably over the remaining months in the . . . amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

H.R. REP. NO. 103-213, at 685 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1374.

¹⁰⁵ Under this approach, known as the “variable contingent payment” method of depreciation, a taxpayer adds the amount of the contingent payments to the basis of the patent and then immediately takes a depreciation deduction for an equal amount. The government has sanctioned the variable contingent payment method. See Treas. Reg. § 1.167(a)-14(c)(4) (as amended in 2006); see also *Associated Patentees, Inc. v. Comm’r*, 4 T.C. 979, 985-87 (1945), *acq.*, 1959-2 C.B. 3 (sanctioning deduction for variable contingent payments); *Allied Tube & Conduit Corp. v. Comm’r*, 34 T.C.M. (CCH) 1218 (1975) (recognizing that deducting yearly payments on a patent is a reasonable method of depreciation); Rev. Rul. 67-136, 1967-1 C.B. 58 (following the *Associated Patentees* decision).

¹⁰⁶ *Associated Patentees*, 4 T.C. at 986 (concluding that a current deduction for the entire contingent payment gives the taxpayer “a reasonable, and not more than a reasonable,” depreciation allowance, whereas permitting as depreciation only a proportionate part of the payment “might deny petitioner the recovery of its cost and would unquestionably result in a distortion of income”).

C. *Inequities in the Tax Treatment of Intellectual Property Transfers*

Like the tax treatment of acquisition costs, the tax treatment of intellectual property transfers raises a number of equity concerns. Consider the following example involving the assignment of two patents. Individual A, a freelance inventor, sells one of his many developed patents to a third party for \$100,000. XYZ, Inc., a small research company whose employees conduct research, sells one of its many developed patents to a third party for \$100,000. Although one would expect the tax system to treat Individual A and XYZ, Inc. similarly, that is not the case. Individual A's gain will be treated as *capital gain* under the Code's safe-harbor provision in Section 1235;¹⁰⁷ XYZ, Inc.'s gain, on the other hand, will be treated as *ordinary income* under the Code's general provisions.¹⁰⁸ Section 1235 requires that the transferor is a statutorily defined "holder" of the patent—i.e., any individual whose personal efforts created the patent property—to be guaranteed capital-gains treatment.¹⁰⁹ So, here, Individual A can qualify for capital-gains treatment under Section 1235 even though the subject of the sale (i.e., the inventory being sold) is not considered a capital asset under general characterization principles.¹¹⁰ XYZ, Inc.'s assignment, however, will not qualify for Section-1235 treatment, but will instead be treated as a sale of a noncapital asset yielding ordinary income.¹¹¹

¹⁰⁷ I.R.C. § 1235 (2006).

¹⁰⁸ *Id.* §§ 1222 (requiring the sale or exchange of a "capital asset" for preferential capital-gains treatment), 1221(a)(1) (excluding inventory from the capital asset definition), 1231(b) (excluding inventory from the quasi-capital asset definition).

¹⁰⁹ *Id.* §§ 1235(a), (b)(1); Treas. Reg. § 1.1235-2(d)(1)(i) (as amended in 1980). More specifically, the regulations provide that a holder is any individual whose efforts created the patented property and who would qualify as the "original and first" inventor, or joint inventor, under the patent laws. Treas. Reg. § 1.1235-2(d)(1)(i) (referring to Title 35 of the U.S. Code). An inventor's employer would not qualify as a holder "even though he may be the equitable owner of the patent by virtue of an employment relationship with the inventor." S. REP. NO. 83-1622, at 423 (1954) (Comm. Rep.), reprinted in 1954 U.S.C.C.A.N. 4621, 50883.

¹¹⁰ I.R.C. § 1221(a)(1) (2006) (excluding from capital asset definition inventory and inventory-like property).

¹¹¹ Although corporations do not get lower rates on their capital gains, capital gains can be used by a corporation to absorb capital losses the corporation may have. *See id.* § 1211(a) (providing that a corporation's capital losses are allowed only to the extent of the corporation's capital gains).

Similar distinctions apply to copyright assignments. For example, songwriters are subject to capital-gains tax rates on the sales of their songs rather than higher personal income tax rates as a result of a special Code provision enacted in 2006 governing musical compositions and the copyrights thereon.¹¹² Peculiarly, capital-gains treatment is not available to other individual artists, such as novelists, painters, sculptors, and designers.¹¹³ Moreover, although individual copyright creators have ordinary gain on the sale of their works (with the exception of musical copyrights, as noted), corporate copyright creators are eligible for capital gains on the sale of works created by their employees and individual contractors.¹¹⁴ This additional distinction results from the fact that the capital-asset exception for self-created property does not apply to non-individual creators, such as corporations, whose employees or independent contractors created the copyrights.¹¹⁵ These distinctions lack any theoretical justification.

Current charitable deduction rules for intellectual property donations also raise equity concerns. These deduction rules favor income-generating intellectual property over non-income-generating intellectual property.¹¹⁶ Moreover, they favor donors that give income-generating intellectual property to commercially-driven charities over donors that give similar property to non-commercially-driven charities.¹¹⁷ Consider two corporations planning to donate similar technologies with equal values. ABC Company makes a donation to a large university that will use the intellectual property in ways that directly generate income. XYZ Company, however, makes its donation to a small college that emphasizes education and basic research. Prior to 2004, the Code granted both companies an initial tax deduction for the same amount—the fair-market

¹¹² *Id.* § 1221(b)(3).

¹¹³ Section 1221(b)(3) applies only to musical compositions and copyrights thereon. *Id.* Individual artists, such as novelists, painters, sculptors, and designers are subject to the general capital-gains provisions. *See id.* §§ 1221(a)(3) (excluding from capital asset definition self-created copyrighted works), 1231(b)(1)(C) (excluding from the definition of Section 1231 property self-created copyrighted works).

¹¹⁴ *Id.* §§ 1221-1222.

¹¹⁵ *See* Rev. Rul. 55-706, 1955-2 C.B. 300, *superseded by* Rev. Rul. 62-141, 1962-2 C.B. 181 (applying inventory exclusion, but not copyright exclusion, suggesting that the copyright exclusion does not apply to works-for-hire creations); *see also* Desilu Prods., Inc. v. Comm'r, 24 T.C.M. (CCH) 1695 (1965) (same).

¹¹⁶ For discussion of these charitable deduction rules, *see infra* notes 119-20 and accompanying text.

¹¹⁷ *See infra* notes 119-20 and accompanying text.

value of the donated property.¹¹⁸ As amended, the Code does not grant either company a fair-market value deduction in the year of the gift.¹¹⁹ The Code, however, does give ABC Company future charitable tax deductions equal to a certain percentage of the royalty income earned by its chosen donee, the commercially driven university.¹²⁰ Because the small college's utilization of XYZ Company's donated intellectual property will not directly generate income, XYZ receives no tax benefit for its charitable giving. In practice, then, charitable deduction rules favor intellectual property used in applied research over that used for fundamental or purely scientific research, and favor donors who give to donees with the physical facilities, financial resources, and personnel capability to exploit intellectual

¹¹⁸ Since 1917, the government has provided a financial incentive for taxpayers to transfer property to charities by giving taxpayers an immediate tax deduction for their donations. See War Revenue Act of 1917, Pub. L. No. 65-50, § 1201(2), 40 Stat. 300, 330 (allowing a charitable tax deduction for contributions by individuals); Revenue Act of 1935, Pub. L. No. 74-407, § 102(c), 49 Stat. 1014, 1016 (codified as amended at I.R.C. § 170 (2006)) (allowing a charitable tax deduction for contributions by corporations).

Historically, the amount of the taxpayer's charitable contribution deduction was the fair market value of the property contributed. See, e.g., Rev. Rul. 58-260, 1958-1 C.B. 126 ("The fair market value of an undivided present interest in a patent, which is contributed by the owner of the patent to an organization described in Section 170(c) . . . constitutes an allowable deduction as a charitable contribution, to the extent provided in Section 170, in the taxable year in which such property was contributed."); H.R. REP. No. 91-413, at 53 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1699 (providing that taxpayer who contributed appreciated property to charity was allowed deduction for fair market value of property); Treas. Reg. § 1.170A-1(c) (as amended in 2008) ("If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) . . ."). The government defined "fair market value" as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 1.170A-1(c)(2) (as amended in 2008). The government, however, never fully articulated or formalized a standard or approach for determining the fair market value of donated intellectual property.

¹¹⁹ In 2004, in a drastic and hasty move, Congress amended the charitable deduction provision by eliminating the fair market value standard for contributions of most all forms of intellectual property, reducing the initial amount a donor may deduct. See I.R.C. § 170(e)(1)(B)(iii) (2006), *amended by* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. The 2004 legislation limits the initial charitable deduction of any type of intellectual property to the property's tax basis. Often, the donor's tax basis in intellectual property is very small; in many cases, the donor's basis is zero because developments costs are often deducted when incurred.

¹²⁰ To encourage charitable giving of intellectual property, Congress deemed it appropriate to grant donors of intellectual property future charitable deductions based on the income received by the donee charity. I.R.C. § 170(m)(3) (2006). Specifically, the donor can take a deduction for up to ten years for gifts of royalty-producing intellectual property to public charities. The amount of the charitable deduction is a percentage of the royalty income earned by the donee. The percentage declines over time. *Id.* §§ 170(m)(1), (7).

property solely for direct financial results—a result that violates notions of fairness.¹²¹

In sum, numerous tax inequities exist for intellectual property developers, acquirers, and transferors. Many of these inequities encourage taxpayers to plan transactions that minimize taxes. If a taxpayer identifies a business's patent that it would like to purchase for contingent payments, the taxpayer receives greater immediate tax deductions if it can negotiate the purchase of the patent separately from the seller's other business assets.¹²² A taxpayer planning to donate income-generating intellectual property to a charity will receive larger tax deductions if it donates the property to a donee that can use the intellectual property in ways that will directly generate income, rather than a non-commercially-driven donee.¹²³ These decisions should be tax-neutral. But under the present tax regime, they are not.¹²⁴

III. EXPLORING EFFICIENCY IN THE INTELLECTUAL PROPERTY TAX SYSTEM

In addition to fairness concerns, an income tax system governing intellectual property should embrace the principle of efficiency.¹²⁵ In tax theory, efficiency means various things in various contexts.¹²⁶ A tax system can be evaluated in terms of the extent to which it promotes or hinders economic growth; it is efficient when it promotes economic growth and inefficient when it stifles beneficial economic behavior.¹²⁷ In addition to promoting economic efficiency, a tax system can also be judged in terms of administrative efficiency—namely, the extent to which it minimizes taxpayer compliance and government enforcement costs.¹²⁸ Thus, the current intellectual property

¹²¹ See generally Xuan-Thao Nguyen & Jeffrey A. Maine, *Giving Intellectual Property*, 39 U.C. DAVIS L. REV. 1721 (2006).

¹²² As previously noted, the treatment of contingent payments for patents acquired separately (current deduction) is more generous than the treatment of contingent payments for patents that are acquired with a trade or business (deferral and amortization over fifteen years). See *supra* notes 104-06 and accompanying text.

¹²³ Charitable tax deductions (beginning with the donation year) equal a percentage of income generated by the donated intellectual property. See *supra* note 120.

¹²⁴ See *supra* notes 104-06, 116-21 and accompanying text.

¹²⁵ See *supra* notes 16-21 and accompanying text.

¹²⁶ See *supra* note 16 and accompanying text.

¹²⁷ See *supra* notes 17-21 and accompanying text.

¹²⁸ See Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395 (1987); Yorio, *supra* note 18, at 1256-57.

taxation system should be analyzed in terms of both economic and administrative efficiency. The current taxation policies applicable to the development and transfer of new technology provide an excellent example of the inefficiencies in the existing regime.

A. *Limits of Current Incentives for Technology Development*

The Internal Revenue Code contains certain provisions designed to promote economic growth and improve the competitiveness of U.S. businesses by encouraging research and development.¹²⁹ These provisions provide a tax deduction and a tax credit for certain technology development costs.¹³⁰ They are also intended to reduce uncertainty and complexity encountered when applying general tax rules to intellectual property transactions. In practice, however, these tax incentives have been an inadequate method of realizing their underlying goals.

Section 174¹³¹ provides a deduction for research expenditures.¹³² Since this deduction applies only to inventors who use, or intend to use, their research results in a trade or

¹²⁹ For a discussion and critique of these Code provisions, see *infra* notes 131-47 and accompanying text.

¹³⁰ Section 174 was enacted to encourage research activity and stimulate economic growth and technological development. H.R. REP. NO. 83-1337 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4053; 100 CONG. REC. 3425 (1954) (statement of Chairman Reed: "This provision will greatly stimulate the search for new products and new inventions upon which the future economics and military strength of our Nation depends. It will be particularly valuable to small and growing businesses."); see also Donald C. Alexander, *Research and Experimental Expenditures Under the 1954 Code*, 10 TAX L. REV. 549 (1955) (noting that a primary reason for enacting Section 174 was to create an incentive for new products and inventions through federal subsidy of research and development startups); William Natbony, *The Tax Incentives for Research and Development: An Analysis and a Proposal*, 76 GEO. L.J. 347, 349 (1987) (explaining that Congress decided "to provide taxpayers with the option of an immediate deduction" in order "to encourage new [research and development]"); Richard L. Parker, *The Innocent Civilians in the War Against NOL Trafficking: Section 382 and High-Tech Start-Up Companies*, 9 VA. TAX REV. 625, 694 (1990) ("The deduction election under section 174(a) is intended to encourage research and development activities by allowing the cost of such activities to be used to offset the income earned in the business at the earliest possible date.").

Section 41 was enacted to encourage firms to increase their research expenditures over time. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 221(a), 95 Stat. 172, 241 (codified as amended at I.R.C. § 41 (2006)). The credit is incremental in that it is equal to a certain percentage of qualified research spending above a base amount, *id.*, which can be thought of as a firm's normal level of research and development investment.

¹³¹ I.R.C. § 174 (2006).

¹³² *Id.*

business,¹³³ it probably does not cover the inventor who merely intends to license the results of her inventive activities for taxable income.¹³⁴ In today's innovation marketplace, however, very few individual inventors, startup companies, and young research entities develop their innovations into end products or services for commercial exploitation.¹³⁵ Instead, most plan to sell or license their innovations to larger companies looking to acquire innovations to supplement their own research or build promising intellectual property portfolios.¹³⁶ To achieve optimal research outcomes and their concomitant economic benefits, then, tax law should recognize and adequately incentivize efforts by individual inventors, startups, and the like—regardless of whether their motives are to use research results in a trade or business, or simply to license research results.

Parallel to Section 174's research deduction, the Code provides a 20% research credit under Section 41.¹³⁷ The Section 41 credit, like the deduction, is inadequate. The credit applies only to qualified research expenditures in excess of a base amount that is a "fixed-base percentage" of the taxpayer's "average annual gross receipts" for the four preceding tax years.¹³⁸ For established firms, the fixed-base percentage is the ratio of the taxpayer's qualified research expenses to its gross receipts for years 1984 to 1988, capped at 16%.¹³⁹ For startup firms, the fixed-base percentage is set at 3% during the firm's first five tax years, with spending on qualified research and gross receipts; thereafter, the percentage is gradually adjusted to reflect the firm's actual experience, so that by its eleventh

¹³³ See *supra* notes 72-75 and accompanying text.

¹³⁴ A few courts, however, have found a trade or business of inventing and permitted deductions. See *supra* notes 76-79 and accompanying text.

¹³⁵ Reasons for not fully developing innovations may include cost, expertise, facility restrictions, business environment, and personnel concerns. See, e.g., Jonathan Thaw, *Writely Puts Google in Word-Processing Business*, SEATTLE POST-INTELLIGENCER (Mar. 10, 2006), http://seattlepi.nwsource.com/business/262443_googlewritely10.html (reporting the acquisition of a software startup company by Google).

¹³⁶ If an inventor cannot self-develop certain innovations, it looks to others to acquire the innovations. Generally, companies acquire innovations for purposes of further development and production of products and services with the desire to expand or to capture additional market shares. See, e.g., Ben Elgin, *Google Buys Android for Its Mobile Arsenal*, BUS. WK. (Aug. 17, 2005), http://www.businessweek.com/technology/content/aug2005/tc20050817_0949_tc024.htm (stating that Google acquired the twenty-two-month-old startup for its "talented engineers and great technology" with "tremendous potential in developing smarter mobile devices that are more aware of its owner's location and preferences").

¹³⁷ I.R.C. § 41 (2006).

¹³⁸ *Id.* §§ 41(a), (c)(1).

¹³⁹ *Id.* §§ 41(c)(3)(A), (C).

year, the percentage equals the firm's total qualified research expenses relative to its total receipts for the fifth through tenth tax years.¹⁴⁰ The base amount may not be less than 50% of the qualified research expenses for the credit year.¹⁴¹

Although Section 41 was designed to encourage additional private sector investment in research and development,¹⁴² as structured, the Section 41 credit fails to achieve optimal technology results for a number of reasons. First, the credit's reformulation over the years has limited the types of research for which the credit is available. Indeed, not all expenditures that qualify for the research deduction under Section 174 qualify for the research credit under Section 41, due to the latter's special requirements and exceptions. For example, to meet the definitional requirements of "qualified research," substantially all research activities must constitute elements of a "process of experimentation" related to a qualified purpose.¹⁴³ The "process of experimentation" requirement narrows the definition of the term "qualified research"; indeed, the requirements for a process of experimentation under Section 41 continue to be more stringent than the requirements for research and development in the experimental or laboratory sense under Section 174.¹⁴⁴

¹⁴⁰ *Id.* § 41(c)(3)(B). For illustrations of the credit computation, see GARY GUENTHER, CONG. RESEARCH SER., RL31181, RESEARCH TAX CREDIT: CURRENT STATUS AND SELECTED ISSUES FOR CONGRESS 6-17 (2008).

¹⁴¹ I.R.C. § 41(c)(2). Taxpayers may, at their election, compute the research credit under another method—the alternative simplified credit method. Tax Relief and Health Care Act of 2006 § 104, I.R.C. § 41(c)(5) (2006). The alternative simplified credit method is an amount equal to 14 percent of the amount by which "the qualified research expenses . . . exceed[] 50 percent of the average qualified research expenses for the [three preceding] taxable years . . ." I.R.C. § 41(c)(5)(A) (2006). For taxpayers with no qualified research expenses for the three preceding years, the amount of the alternative simplified credit is "equal to 6 percent of the qualified research expenses for the [current] taxable year." *Id.* § 41(c)(5)(B).

¹⁴² Studies have shown that the credit has led to increased research spending. *See, e.g.*, CONG. BUDGET OFFICE, FEDERAL SUPPORT FOR RESEARCH AND DEVELOPMENT (2007); GEN. ACCOUNTING OFFICE, GAO/GGD-89-114, THE RESEARCH TAX CREDIT HAS STIMULATED SOME ADDITIONAL RESEARCH SPENDING (1989).

¹⁴³ I.R.C. § 41(d)(1) (2006).

¹⁴⁴ *See* 69 Fed. Reg. 22, 24 (Jan. 2, 2004) ("[M]erely demonstrating that uncertainty has been eliminated . . . is insufficient to satisfy the process of experimentation requirement. A taxpayer bears the burden of demonstrating that its research activities additionally satisfy the process of experimentation requirement."); *see also* Treas. Reg. § 1.41-4(a)(5)(i) (as amended in 2004) ("[A] process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities.").

Second, the incremental nature of the credit means that many businesses cannot utilize it at all. This could be the case, for example, if a company's gross sales grew faster than its qualified research spending. Calculating today's credit based on research spending relative to receipts in the years 1984 to 1988 does not reflect realities of today's economic and technological world, and it could penalize a company that had high research spending levels during the 1984 to 1988 base period (unless the alternative formula provided a benefit).¹⁴⁵

Third, the nonpermanent nature of the credit makes it difficult for firms to plan ahead for research activities. The credit is only temporary and has been extended numerous times by Congress. In fact, since its enactment in 1981, the credit has been extended more than a dozen times, sometimes retroactively after expiration.¹⁴⁶ Efforts to make the credit permanent have failed due to revenue concerns.¹⁴⁷ So, every credit renewal year, the government must balance its desire to maximize tax revenue without stifling beneficial research and development activity.

B. Limits of Current Incentives for Technology Transfers

Under the current system, tax incentives for research are limited to the innovation-development market.¹⁴⁸ In recent years, however, there has been a major shift in the innovation-development market toward a segmentation model. Small companies and research universities now serve as epicenters of ideas, complementing and maximizing the innovations of large established firms with strong marketing and distribution forces.¹⁴⁹ The desirable transfers of innovation between segments can be either supported or hindered by the income

¹⁴⁵ See *supra* note 141 (describing the alternative simplified credit method).

¹⁴⁶ See, e.g., I.R.C. § 41(h)(1)(B) (2006).

¹⁴⁷ A one-year extension of the credit, for example, was estimated to cost the government almost \$9 billion over ten years. STAFF OF J. COMM. ON TAXATION, 110TH CONG., ESTIMATED REVENUE EFFECTS OF H.R. 6049, at 4 (Comm. Print 2008), available at <http://www.jct.gov/publications.html?func=startdown&id=1293>.

¹⁴⁸ See I.R.C. §§ 41 (providing limited tax credit for qualified research expenses), 174 (providing current tax deduction for research and experimental expenditures), 1235 (guaranteeing preferential capital-gains rate treatment for certain inventors).

¹⁴⁹ See generally Michael J. Kennedy, *Technology and Emerging Growth Acquisitions: The Private Perspective*, in HANDLING HIGH-TECH M&AS IN A COOLING MARKET: ENSURING THAT YOU GET VALUE 921, 923-25 (Practising Law Institute, 2001) (discussing the flexibility associated with deals between private and public companies).

tax system. Favorable tax rules governing assignments to private market acquirers and donations to public charities could serve to encourage transfers to the right acquirers for further research, product development, or licensing—thereby increasing economic growth.¹⁵⁰ Here, again, the tax rules could also facilitate administrative efficiency by removing unnecessary complexity in their application. This type of tax scheme would support the business and technology realities of today's innovation segmentation, allow new ideas to develop at a faster pace, and foster strong competition. The current tax system, however, is not designed as such. Currently, there are inefficiencies in the tax scheme covering both private market transactions and charitable donations of technology.

1. Private-Market Transactions

With respect to private-market transactions, the income tax system could be used to create incentives for transferors or transferees—or both. Presently, few *transferors* are guaranteed preferential capital-gains treatment on the assignment of their inventions.¹⁵¹ Section 1235 of the Code guarantees capital-gains treatment only to individuals—i.e., the original inventors that assign all substantial rights to their inventions;¹⁵² it does not apply to the more common startup companies and small research entities whose employees conduct their research.¹⁵³ As a result, these developers must apply general tax rules to determine the character of their gains, and these gains are often characterized as ordinary income, especially if the firm has sold a number of inventions over the years.¹⁵⁴

¹⁵⁰ For an argument that greater tax incentives for purchasers of intellectual property may encourage desirable transfers of intellectual property, see *infra* notes 155-78 and accompanying text. For an argument that revised charitable deduction rules may encourage desirable donations of intellectual property, see *infra* notes 179-84 and accompanying text.

¹⁵¹ See I.R.C. § 1235 (2006).

¹⁵² Section 1235 guarantees capital-gains rates, as opposed to higher ordinary income tax rates, for any transfer of all substantial rights to a patent by certain holders to unrelated parties. *Id.* § 1235(a). “[A]ny individual whose efforts created such property” qualifies as a “holder” for purposes of Section 1235. *Id.* § 1235(b)(1).

¹⁵³ Although Section 1235 does not apply to companies, “each member of a partnership who is an individual[, however,] may qualify as a holder as to his [pro-rata] share of a patent owned by the partnership.” Treas. Reg. § 1.1235-2(d)(2) (as amended in 1980).

¹⁵⁴ I.R.C. §§ 1221(a)(1), 1231(b)(1)(A)-(B) (2006) (precluding inventory and inventory-type property from qualifying for capital-gains treatment). Although corporations do not enjoy lower rates on capital gains, capital gains can be used to offset capital losses the corporation may have. *Id.* § 1211(a) (“In the case of a

Likewise, *transferees* of high technology receive few breaks for their acquisition costs under the current regime. Without exception, purchasers of technology are subject to the general asset-capitalization rule, which requires them to capitalize all costs of acquiring technology.¹⁵⁵ This rule, of course, raises the costs of products that have a high technology content. To remedy this effect, the government could depart from the asset-capitalization principle and instead allow limited expensing of innovation purchase costs. Although the government has never considered doing so, it has, since 1981, permitted small business taxpayers to elect to immediately deduct the cost of purchasing certain tangible property that would otherwise have to be capitalized (e.g., business machines and equipment, transportation equipment, and communications equipment).¹⁵⁶ The extension of this expense allowance to certain innovation acquisition costs would represent a significant tax subsidy for innovation investment and achieve other important goals. Chiefly, it would lower the cost of capital for innovations used in an active trade or business, which, in turn, would reduce the tax burden on innovation acquirers, and stimulate business investment and the economy as a whole. Policymakers had these goals in mind when they enacted special expensing provisions for tangible property.¹⁵⁷ These objectives are equally applicable to intangible innovations.

Moreover, expanding the expense allowance for limited acquisition costs would eliminate high administrative costs and reduce the harm caused by current irrational tax depreciation rules. Some commentators have argued that the capitalization of costs is warranted only if followed by rational depreciation

corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.”).

¹⁵⁵ *Id.* § 263 (2006); Treas. Reg. §§ 1.263(a)-4(b)(1)(i), -4(c) (2004) (“[A] taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction.”).

¹⁵⁶ I.R.C. § 179 (2006). The type of property to which the election applies is “section 179 property,” defined generally as tangible, depreciable, personal property—as opposed to real property—that is acquired for use in the active conduct of a trade or business. *Id.* § 179(d)(1). As a result of the Jobs and Growth Tax Relief and Reconciliation Act of 2003 § 202(c), Pub. L. No. 108-27, 117 Stat. 752, off-the-shelf computer software was added to the list of Section 179 property.

¹⁵⁷ See GARY GUENTHER, CONG. RESEARCH SERV., RL 31852, SMALL BUSINESS EXPENSING ALLOWANCE: CURRENT STATUS, LEGISLATIVE PROPOSALS, AND ECONOMIC EFFECTS 3-5 (2005) (weighing the costs and benefits of expensing for small businesses).

rules.¹⁵⁸ But the current system is far from rational, supporting the argument that capitalization is not necessarily justified for all intellectual property acquisition costs. As the authors have argued elsewhere, any immediate incentive for acquisition costs, such as the expensing option discussed here, should be limited to innovations acquired for future development or licensing.¹⁵⁹ This incentive should not extend to innovations acquired for offensive-use purposes because the use of patent portfolios to threaten others through litigation actually hinders, rather than promotes, innovation.¹⁶⁰

As an alternative to allowing an expense option for certain innovation acquisitions, the government could design more rational tax depreciation rules that would incentivize desirable innovation acquisitions. When designing new *ex ante* depreciation rules, a decision would have to be made about whether to establish a grouping system for innovations (the current approach for all tangible property¹⁶¹ and intangible property acquired with a business¹⁶²) or an asset-by-asset system (the current approach for intangible property acquired separately)¹⁶³. A grouping system would achieve greater administrative efficiency than an asset-by-asset depreciation system and, if designed properly, could also support a strong acquisition market. Under a grouping system, intellectual property could be grouped into classes with arbitrary recovery periods for each class. This approach would alleviate some of the problems caused by both the asset-by-asset approach—namely, the burden of having to determine the useful life of separately acquired intellectual property—and the income-forecast method.

In selecting an appropriate recovery period for various classes of intellectual property, the government could make an effort to achieve some correlation between the prescribed groupings and the actual economic useful lives of intellectual

¹⁵⁸ See Ethan Yale, *When Are Capitalization Exceptions Justified?*, 57 TAX L. REV. 549, 557-64 (2004) (arguing that flawed depreciation schedules may justify departure from normative capitalization but only in limited cases; otherwise, expensing may be a preferable neutrality-enhancing policy choice).

¹⁵⁹ Nguyen & Maine, *Acquiring Innovation*, *supra* note 4, at 787-92.

¹⁶⁰ *Id.*

¹⁶¹ I.R.C. § 168(b) (2006) (listing various depreciation methods according to type of property).

¹⁶² *Id.* § 197; see *supra* notes 94-95 and accompanying text.

¹⁶³ I.R.C. § 167; Treas. Reg. § 1.167(a)-3 (as amended in 2004), -14 (as amended in 2006); see *supra* notes 96-98 and accompanying text.

property. The correlation between tax depreciation and economic depreciation would not have to be exact. Indeed, the government could design a system that is “accelerated”; many of the recovery periods for intellectual property could be shorter for tax purposes than for economic purposes. Under an accelerated approach, purchasers of intellectual property could recover their costs more quickly tax-wise than economic reality would dictate.

It might be tempting to adhere to a fifteen-year recovery period—the recovery period for many intangible assets under the current scheme (which determines the applicable recovery period based on how the intellectual property was acquired).¹⁶⁴ For many intangibles acquired in a business acquisition, the recovery period is fifteen years. By contrast, an asset-specific approach is used for separately acquired intangibles.¹⁶⁵ Although fifteen years is a short period compared to the unlimited lives of trade secrets, trademarks, and trade names, it is much longer than the useful lives of many acquired patents. The government selected a fifteen-year recovery period so that the new legislation would be approximately revenue-neutral over the first five years.¹⁶⁶ While much can be said for this current revenue-neutral approach, it is not an ideal method of encouraging desirable innovation acquisitions.

The government should consider creating exemptions from the current fifteen-year period for patents, patent applications, software, and other high technology intellectual property purchased in the acquisition of a trade or business. Property of this nature is capable of reasonable valuation and has a relatively short commercial life, no matter how it was acquired. If technology derived its value from its relationship to a product, service, or goodwill of a business (as a trademark or trade names does), it might make sense to provide an arbitrary fifteen-year recovery period to avoid messy valuation and intangible asset-allocation problems. However, high technology acquired as part of the purchase of a company does not

¹⁶⁴ See *supra* notes 94-95 and accompanying text.

¹⁶⁵ See *supra* notes 96-98 and accompanying text.

¹⁶⁶ See STAFF OF J. COMM. ON TAXATION, 103D CONG., TECHNICAL EXPLANATION OF TAX SIMPLIFICATION ACT OF 1993, at 147 (Comm. Print 1993) [hereinafter TECHNICAL EXPLANATION], available at <http://www.jct.gov/publications.html?func=startdown&id=2915> (acknowledging that the asset's useful life may either fall short or exceed the amortization period, but nevertheless establishing such amortization period based on the goal of revenue neutrality over the subsequent five fiscal years).

necessarily derive its value from the goodwill and reputation of the business with which it is associated. High technology can be freely sold, assigned, or transferred without associated goodwill or other business assets.¹⁶⁷ Hence, the depreciation schedule for technology need not parallel the arbitrary fifteen-year schedule application to all intangibles acquired in a business acquisition, such as trademarks and trade names, which lack inherent value.

With regard to technology—whether acquired separately or with a business—short recovery periods, such as three or five years, would incentivize investment in innovation capital. Short recovery periods would also recognize the relatively risky nature of high technology compared to other intangible assets. Risk, such as retirement risk and revenue risk, “can have a significant impact on the optimal design of depreciation rules.”¹⁶⁸ As some economists have argued, “depreciation schedules for relatively risky assets should be accelerated to compensate the owners of such assets for bearing a disproportionately large share of the capital price risk.”¹⁶⁹ It is often difficult to determine whether certain acquired technologies will produce benefits and, if they do, how long benefits will last. For example, if a purchaser acquires technology at an early stage while patent applications for the technology are pending, the purchaser cannot be certain that all of the patent applications will mature to patents. In addition, even after the purchaser receives the patents, there is always a fear that the patents may be subsequently invalidated by a third party.¹⁷⁰

The government has already provided an artificially low recovery period for separately acquired computer software. In

¹⁶⁷ See *supra* notes 101-02.

¹⁶⁸ Jeff Strnad, *Tax Depreciation and Risk*, 52 SMU L. REV. 547, 547 (1999); see also *id.* at 547-48 (“[R]etirement risk must be taken into account in designing an accelerated schedule that does not favor some assets over others.”).

¹⁶⁹ Yale, *supra* note 158, at 572 (citing Jeremy I. Bulow & Lawrence H. Summers, *The Taxation of Risky Assets*, 92 J. POL. ECON. 20, 37-38 (1984); Roger H. Gordon & John Douglas Wilson, *Measuring the Efficiency Cost of Taxing Risky Capital Income*, 79 AM. ECON. REV. 427, 438 (1989)).

¹⁷⁰ See 35 U.S.C. § 282 (2006) (“A patent shall be presumed valid. . . . The burden of establishing invalidity of a patent or any claim thereof shall rest on the party asserting such invalidity.”); *Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350, 1360 (Fed. Cir. 1984) (holding that the presumption of validity must be overcome by clear and convincing evidence); William Alsup, *A District Judge’s Proposal for Patent Reform: Revisiting the Clear and Convincing Standard and Calibrating Deference to the Strength of the Examination*, 24 BERKELEY TECH. L.J. 1647, 1648 (2009) (“[A]t least one-third of patent claims asserted in litigation should never have issued.”).

1993, Congress created an arbitrary three-year depreciation period for capitalized costs of separately acquired software (i.e., software that is not acquired as part of the purchase of a trade or business).¹⁷¹ This recovery period reduces the cost of, and encourages investment in, computer software, allowing U.S. firms to compete in the world marketplace. The government could extend the three-year recovery period for computer software to similar high technology intellectual property, for example, advanced formulae, processes, or design patterns.¹⁷²

Admittedly, short write-off periods, such as those proposed here, run counter to the basic goal of tax depreciation—i.e., to measure the decline in the value of property due to wear, tear, and obsolescence, and to match the cost recovery of the property with the income stream produced by the property.¹⁷³ But this matching goal is difficult to achieve and, in recent years, has given way to the desire for tax simplification and economic growth.¹⁷⁴ In the 1980s, Congress created artificially low recovery periods for depreciable tangible property (three, five, and seven years in most cases).¹⁷⁵ And recently, courts have permitted rapid write offs of antique tangible property used in a trade or business, even though antiques do not have a determinable useful life and usually increase in value.¹⁷⁶ In 1993, Congress created a fifteen-year recovery period for many intangibles, some of which have unlimited lives and were before then considered ineligible for depreciation allowances.¹⁷⁷ These rules increase tax revenue loss for the government, but the resulting losses are considered outweighed by the benefits of lower efficiency costs and the

¹⁷¹ See *supra* note 97 and accompanying text.

¹⁷² *Tax Treatment of Intangible Assets: Hearing on S. 1245, H.R. 3035 & H.R. 4210 Before the Comm. on Fin.*, 102d Cong. 160-61 (1992) (statement of the Elec. Indus. Ass'n) (arguing a shorter recovery period is warranted for high technology intellectual property since such property is very similar to computer software).

¹⁷³ 1997 U.S.C.C.A.N. 908.

¹⁷⁴ The tax expensing and tax depreciation rules for tangible property are prime examples. See, e.g., I.R.C. § 168 (2006) (providing arbitrarily short recovery periods for most depreciable tangible personal property); *id.* § 179 (providing limited expensing of the cost of purchasing depreciable tangible personal property).

¹⁷⁵ *Id.* §§ 168(c), (e).

¹⁷⁶ See, e.g., *Simon v. Comm'r*, 68 F.3d 41 (2d Cir. 1995) (allowing tax depreciation for antique violin bows even though the taxpayers could not demonstrate that the bows had a determinable useful life).

¹⁷⁷ Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 107 Stat. 312 (codified as amended at I.R.C. § 197 (2006)); see *supra* notes 94-95 and accompanying text.

potential competitive advantages to be gained by U.S. businesses.¹⁷⁸

2. Public Charitable Transfers

In the current innovation development segmentation market, many universities and other not-for-profit organizations engage in valuable research activities. An efficient tax system should encourage transfers of undeveloped innovation to such charitable donees. Historically, the charitable tax deduction was a vital tool for transferring technology from research corporations to universities and other nonprofit donees that could properly exploit the technology.¹⁷⁹

As a result of 2004 legislation aimed at reducing the number of negligent and intentional overvaluations of intellectual property donations, there is now very little immediate economic incentive for charitable donations of any type of intellectual property.¹⁸⁰ Presently, few technology donors receive any immediate tax benefit for their contributions.¹⁸¹ Donors can take future deductions if the donated intellectual property generates income for the charitable donee.¹⁸² But providing donors with uncertain and declining future economic incentives does not adequately encourage intellectual property donations. Even if a charitable donee licenses the donated

¹⁷⁸ For early arguments for and against depreciation deductions for trademarks and trade names, see Michael J. Dunne & Elizabeth A. Barba, *The Tax Treatment of Trademarks Gets Renewed Attention in Congress*, NAT'L L.J., May 11, 1992, at S15.

¹⁷⁹ Large corporations with research and development facilities often develop patents that later become "not consistent with [their] core technologies or mission," that are "not appropriate for licensing to third parties," or that have "no value for defensive purposes in competitive markets." RON LAYTON & PETER BLOCK, INT'L INTELLECTUAL PROP. INST., IP DONATIONS: A POLICY REVIEW 5 (2004), available at http://s251835929.onlinehome.us/reports/IP_Donations_Policy_Review.pdf. For example, Dow Chemical reportedly donated 10,000 patents to qualified charitable organizations over a five-year period. *Id.* at 6.

¹⁸⁰ See *supra* notes 118-21 and accompanying text.

¹⁸¹ Presently, the initial charitable deduction amount is the lesser of the taxpayer's tax basis in the donated intellectual property or the fair market value of the intellectual property at the time of contribution. I.R.C. § 170(e)(1)(B) (2006). In most cases, where intellectual property appreciates in value, the lesser amount is the donor's tax basis. Often the donor's tax basis in intellectual property is very small; in many cases, the donor's basis is zero because intellectual property development costs are often deducted when incurred. See, e.g., *id.* § 174.

¹⁸² More specifically, a donor is allowed deductions for a limited number of years based on a specified percentage of the qualified donee income "received by or accrued to" the charity from the donated property itself, rather than income stemming from the activity in which the donated property is used. *Id.* § 170(m).

intellectual property, the potential future deduction will not be substantial enough. It may take the charity several years before it receives any financial return on its donated intellectual property. While the intellectual property may begin generating royalty revenues immediately, under the new law, the amount of future charitable deductions declines annually on a sliding scale.¹⁸³ Indeed, in the tenth post-contribution year, the donor may deduct only 20% of the income.¹⁸⁴

C. *Administrative Inefficiencies Under Current Intellectual Property Tax Regime*

In addition to promoting economic efficiency, the general rule is that a good tax system should also be administratively efficient; it should provide certainty and clarity to minimize costs of compliance and administration. Many of the special rules governing intellectual property were enacted to reduce uncertainty and complexity encountered when applying general tax rules to intellectual property transactions. For example, Section 174 reduced uncertainties in the application of the asset-capitalization rule to research and development expenditures.¹⁸⁵ Likewise, Section 1235 clarified the tax treatment of patent transfers,¹⁸⁶ and Section

¹⁸³ *Id.* §§ 170(m)(1), (7).

¹⁸⁴ *Id.* § 170(m)(7).

¹⁸⁵ While one justification for Section 174 was to encourage new research and development activity and stimulate economic growth and technological development, another justification was “to reduce uncertainty caused by the application of the asset-capitalization rules to” research and development activities. George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1258-59 (1987); see also David S. Hudson, *The Tax Concept of Research or Experimentation*, 45 TAX LAW. 85, 88-89 (1991) (explaining that the old capitalization rule was difficult to apply to research and development costs).

¹⁸⁶ While Section 1235 was intended to encourage research and development that potentially lead to patentable inventions, it also resulted in reduced uncertainty and minimized disputes over the application of general tax principles to patent transfers. For example, when applicable, Section 1235 provides statutory assurance that a patent transfer will not be deemed a license merely because of the existence of contingent payments. I.R.C. § 1235(a) (2006) (providing that Section 1235 applies regardless of whether the payments received are “(1) payable periodically over a period generally coterminous with the transferee’s use of the patent, or (2) contingent on the productivity, use, or disposition of the property transferred”); see also S. REP. NO. 83-1622, at 422 (1954) (Comm. Rep.), reprinted in 1954 U.S.C.C.A.N. 4621, 5082 (stating that Section 1235 was intended “to give statutory assurance to certain patent holders that the sale of a patent (whether as an ‘assignment’ or ‘exclusive license’) shall not be deemed not to constitute a ‘sale or exchange’ for tax purposes solely on account of the mode of payment”).

Section 1235 also eliminates uncertainty over whether a patent transferor is an amateur (who is eligible for capital-gains treatment under general tax principles)

1253 alleviated uncertainties and much litigation regarding the tax treatment of trademark and trade name transfers.¹⁸⁷ Section 197, similarly, was enacted “to simplify the rules for depreciating intangibles and to reduce the number of controversies arising from the need to determine which intangibles are depreciable and what their recovery periods should be.”¹⁸⁸

The problem is that few of the special tax rules are conclusive; they contain many limitations, ambiguities, and exceptions. The consequence is that the tax outcome for many intellectual property assets and transactions is determined under the general tax rules—the same rules that were the initial source of complexity. For example, if Section 174 does

or a professional inventor (who is not eligible for capital-gains treatment under general tax principles). H.R. REP. NO. 83-1337, at 85 (1954) (Comm. Rep.), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4108; S. REP. NO. 83-1622, at 112 (1954) (Comm. Rep.), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4747.

Section 1235 also eliminates the need to ascertain the holding period of an invention for purposes of meeting the requisite one-year holding period under the general capital-gains provisions. I.R.C. § 1222(3) (2006) (“[L]ong-term capital gain’ means gain from the sale or exchange of a capital asset held for more than 1 year . . .”).

If the requirements of Section 1235 are met (i.e., there exists a transfer of “all substantial rights” by a “holder” to an “unrelated party,” as those terms are defined for purposes of section 1235), then a patent transferor is assured capital-gains treatment. *Id.* § 1235(a). Determinations of what constitutes a “sale” or a “capital asset” are made under general sale or exchange principles. *See id.* §§ 1221, 1222, 1231 (general capital-gains provisions).

¹⁸⁷ Prior to the enactment of Section 1253 in 1969, there was confusion over the proper tax consequences of trademark and trade name dispositions. In particular, there was considerable diversity of opinion among courts over what sorts of interests retained by transferors should preclude capital-gains treatment and uncertainty over the impact of contingent payments in trademark and trade-name transfers. Congress enacted the Tax Reform Act of 1969 § 516, I.R.C. § 1235 (2006), to bring clarity to this area of the law. *See* S. REP. NO. 91-552, at 198 (1969) (Comm. Rep.), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2242-43; H.R. REP. NO. 91-413, at 1815-16 (1964) (Comm. Rep.), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1815-16.

Section 1253 mandates ordinary income treatment on all payments that are “contingent on the productivity, use, or disposition” of a trademark or trade name. I.R.C. § 1253(c) (2006) (emphasis added). Section 1253 imposes ordinary income treatment on *noncontingent* payments (whether up-front or installment payments) received for the transfer of a trademark or trade name “if the transferor retains any significant power, right, or continuing interest with respect to the subject matter” of the mark or name. *Id.* § 1253(a). The Code sets forth six potentially significant powers, any one of which, if retained, would require ordinary income treatment. *Id.* § 1253(b)(2). This list of retained powers is not exhaustive; rather, consideration is given to all the facts and circumstances existing at the time of a transfer to determine whether an unenumerated power constitutes a significant power. For example, the duration of the relevant restriction is important in determining whether the restriction is significant. *Stokely USA, Inc. v. Comm’r*, 100 T.C. 439, 453, 456-57 (1993) (finding that a five-year right to disapprove a transfer was insignificant, while a twenty-year restriction preventing the transferee from using the trademark on certain products was significant).

¹⁸⁸ Mary LaFrance, *Days of Our Lives: The Impact of Section 197 on the Depreciation of Copyrights, Patents, and Related Property*, 24 HOFSTRA L. REV. 317, 320 (1995).

not apply, a taxpayer must capitalize the research costs.¹⁸⁹ However, complex questions arise in applying the asset-capitalization principle to research costs. For example, when do research activities result in an identifiable asset? How does one apportion the costs if a particular project partly succeeds and partly fails, or if different and simultaneous research activities contribute in varying degrees to the development of an asset or more than one asset?

Similarly, if Section 1235 does not apply to patent assignments, the general sale or exchange principle must be applied to determine the tax treatment of a particular transfer.¹⁹⁰ But difficult-to-answer questions with respect to technology—questions that justified adoption of the special rule—must be addressed: Does the transfer constitute a sale? Is the subject of transfer a capital asset? What is the holding period?

Likewise, if Section 197 does not apply to an intellectual property acquisition, tax depreciation allowances are determined under the asset-specific approach that applied before enactment of the special provision—under the straight-line or income-forecast method.¹⁹¹ This approach sets up unnecessary rule, compliance, and transactional complexity—raising the question of why there are different depreciation methods and different write-off periods for the same type of technology that depend solely on the method of technology transfer.¹⁹²

The new charitable deduction rules applicable to technology contributions are a classic example of a recent tax law change that was designed to enhance administrative efficiency but only increased inefficiency. The new law's focus on future tax deductions imposes heavy administrative

¹⁸⁹ The Section 174 deduction is an exception to the general asset-capitalization principle of Section 263. I.R.C. § 263(a)(1)(B) (2006). If Section 174 does not apply, the research and development costs must be capitalized. *See id.*

¹⁹⁰ Section 1235 is a safe-harbor provision providing all the elements necessary for capital-gains treatment. *Id.* § 1235(a) (providing that a transfer “shall be considered the sale or exchange of a capital asset held for more than 1 year”). If Section 1235 does not apply (e.g., the transfer does not consist of all substantial rights to a patent by a holder), the general capital-gains provisions apply (i.e., capital-gains treatment is only available if the transfer constitutes a “sale or exchange of a capital asset”). *See id.*

¹⁹¹ When applicable, Section 197 is used to determine cost recovery deductions. *Id.* § 197(b). When inapplicable, general depreciation principles apply. Treas. Reg. § 1.167(a)-14 (as amended in 2006).

¹⁹² *Tax Treatment of Intangible Assets: Hearing on S. 1245, H.R. 3035 & H.R. 4210 Before the Comm. on Fin.*, 102d Cong. 52 (1992) (statement of William P. Benac).

burdens, including modified and expanded record-keeping requirements, on both intellectual property donors and charitable donees.¹⁹³ Because the new law allows donors to take deductions over a period of years determined based upon the income derived from the donated property, the donor and the donee organization must communicate with one another and with the IRS for several years following a qualified contribution.¹⁹⁴ By allowing future deductions to be based on income received or accrued by the charity from the donated property itself, rather than from income stemming from the activity in which the donated property is used, the new law places the difficult burden on charities of tracking their specific intellectual property assets. Moreover, with regard to considering future tax deductions at stake under the new law, donors will incur substantial monitoring costs.

IV. DEVELOPING A LEGAL FRAMEWORK FOR INTELLECTUAL PROPERTY TAXATION

From an equity and efficiency standpoint, there are fundamental flaws in the current intellectual property tax regime. These defects can be attributed to the absence of an appropriate legal framework for intellectual property tax legislation.¹⁹⁵ The current regime evolved over time as particular concerns arose, but at no time was a framework of rational intellectual property and tax policy objectives used in developing rules to ensure a sound system.¹⁹⁶ The following

¹⁹³ Donors must inform charitable donees of their intent to treat the contribution as a "qualified intellectual property contribution" and take additional deductions in subsequent years based on the income accrued from the donated property. I.R.C. § 170(m)(8)(B). Charitable donees must provide donors with written substantiations explaining the amount of income derived from the donated intellectual property during the tax year. *Id.* § 6050L(b)-(c). Further, charitable donees must file an annual information return reporting their qualified donee income and other specified information. *Id.*

¹⁹⁴ See *id.* §§ 170(m)(8)(B), 6050L(b)-(c); Treas. Reg. § 1.6050L-2 (2008).

¹⁹⁵ The Code contains several special rules that govern different types of intellectual property. A few of the special provisions apply equally to a large group of intellectual property assets. See, e.g., I.R.C. §§ 167(g)(6), 170(e)(1)(B)(iii), 170(m), 197 (2006). Most, however, are mutually exclusive, governing specific forms of intellectual property. See, e.g., *id.* §§ 41, 167(f)(1), 167(g)(8), 174, 1221(a)(3), 1221(b)(3), 1235, 1253. Some of these special provisions encourage certain intellectual property activities; some close tax loopholes and remove perceived tax inequities; and some simplify rules and eliminate tax uncertainties that existed under general tax principles. None were enacted within a framework of rational intellectual property and tax policy objectives, as suggested later in this article.

¹⁹⁶ See *supra* note 195.

questions illustrate some important considerations that could help shape an appropriate framework for intellectual property tax legislation. To what extent, if any, should the tax system support the intellectual property system? And to what extent, if any, should the tax system adopt distinctions among intellectual property rights? If tax distinctions are adopted, what is a rational basis for making coherent tax distinctions?

A. *Establishing the Role of the Tax System in Supporting the Intellectual Property System*

Inefficiencies in the intellectual property tax regime may or may not be justified, depending on one's view of whether the tax system should support the intellectual property system. As discussed above, the special tax provisions designed to incentivize innovation¹⁹⁷ have, in practice, failed to achieve this goal.¹⁹⁸ In addition, these special tax rules apply only to the development of patents and patent-like property; they do not extend to other types of intellectual property creation, such as copyrights and trademarks.¹⁹⁹ This tax policy might be deemed efficient if one adopts a narrow view of the overall social and economic benefits derived from intellectual property,²⁰⁰ but under a broader view of intellectual property's positive effects, it might be deemed inefficient. To make this determination, an appropriate legal framework for intellectual property tax rules would consider the extent to which harmonization between the intellectual property and taxation schemes should be achieved. Specifically, what role should the tax system play, if any, in promoting the intellectual property system?

Few people would disagree that encouraging inventions and works of authorship is critical to U.S. economic growth. When the Founding Fathers included the Patent and Copyright Clause of the Constitution,²⁰¹ their words clearly conveyed the

¹⁹⁷ See, e.g., I.R.C. §§ 41 (2006) (credit for limited research expenditures); *id.* § 174 (deduction for limited research expenditures); *id.* § 1235 (capital-gains treatment for limited assignments of innovations in the form of patents).

¹⁹⁸ See *supra* notes 131-47 and accompanying text.

¹⁹⁹ See, e.g., *infra* notes 220-30 and accompanying text.

²⁰⁰ It might be deemed efficient if one accepts a meaning of tax efficiency other than the one used here. Indeed, some might argue that the "efficiency criterion requires that a tax interfere as little as possible with people's economic behavior." GRAETZ & SCHENK, *supra* note 11, at 29 (summarizing several different meanings of tax efficiency); see also *supra* notes 20-25 and accompanying text.

²⁰¹ U.S. CONST. art. I, § 8, cl. 8.

objective of rewarding inventors with exclusive rights in their inventions.²⁰² The Founding Fathers believed that a reward-based system would “promote the Progress of Science.”²⁰³ At the same time, they also understood that unfettered rights would not aid scientific progress and therefore placed a time limit on the exclusivity for patents.²⁰⁴ The patent statute and its subsequent amendments take a similar view.²⁰⁵ For an invention to be granted a patent, it must be, among other

²⁰² See *Seymour v. Osborne*, 78 U.S. (11 Wall.) 516, 533-34 (1871) (“Letters patent are not to be regarded as monopolies . . . but as public franchises granted to the inventors of new and useful improvements for the purpose of securing to them, as such inventors, for the limited term therein mentioned, the exclusive right and liberty to make and use and vend to others to be used their own inventions, as tending to promote the progress of science and the useful arts, and as matter of compensation to the inventors for their labor, toil, and expense in making the inventions, and reducing the same to practice for the public benefit, as contemplated by the Constitution and sanctioned by the laws of Congress.”).

²⁰³ U.S. CONST. art. I, § 8, cl. 8; see also *Pfaff v. Wells Elecs., Inc.*, 525 U.S. 55, 63 (1998) (“The balance between the interest in motivating innovation and enlightenment by rewarding invention with patent protection on the one hand, and the interest in avoiding monopolies that unnecessarily stifle competition on the other, has been a feature of the federal patent laws since their inception.”).

²⁰⁴ See *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989) (“The Patent Clause itself reflects a balance between the need to encourage innovation and the avoidance of monopolies which stifle competition without any concomitant advance in the ‘Progress of Science and useful Arts.’”); *Sears, Roebuck & Co. v. Stiffel Co.*, 376 U.S. 225, 229 (1964) (“Patents are not given as favors . . . but are meant to encourage invention by rewarding the inventor with the right, limited to a term of years fixed by the patent, to exclude others from the use of his invention.”).

As demonstrated in Thomas Jefferson’s writings—which played an influential role in shaping modern patent law—patent grants should only be issued by the government to truly warranted inventions. *Graham v. John Deere Co. of Kansas City*, 383 U.S. 1, 9 (1966) (After a review of Thomas Jefferson’s writings and his influences on shaping the patent system, the Court concluded, “Jefferson did not believe in granting patents for small details, obvious improvements, or frivolous devices. His writings evidence his insistence upon a high level of patentability.”); see also *Bonito Boats*, 489 U.S. at 148 (“Today’s patent statute is remarkably similar to the law as known to Jefferson in 1793. Protection is offered to ‘whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof.’” (quoting 35 U.S.C. § 101 (2006))).

²⁰⁵ See 35 U.S.C. § 101 (defining the categories of patentable invention broadly to include “any new and useful process, machine, manufacture, or composition of matter, or . . . improvement thereof”); *id.* § 103(a) (“A patent may not be obtained . . . if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art . . .”).

things, novel and nonobvious;²⁰⁶ in other words, patents are granted for innovation.²⁰⁷

Similarly, trade secret law was designed to foster innovation and promote responsible business conduct.²⁰⁸ To that end, trade secrets are treated as property, and courts have thus held that regulations forcing trade secret disclosure amount to a governmental taking of property for which the trade secret owner must be justly compensated.²⁰⁹ Moreover, the law

²⁰⁶ See *KSR Int'l Co. v. Teleflex Inc.*, 550 U.S. 398, 419 (2007) (“Granting patent protection to advances that would occur in the ordinary course without real innovation retards progress and may, for patents combining previously known elements, deprive prior inventions of their value or utility.”).

²⁰⁷ See *Qualitex Co. v. Jacobson Prods. Co.*, 514 U.S. 159, 164 (1995) (“It is the province of patent law, not trademark law, to encourage invention by granting inventors a monopoly over new product designs or functions for a limited time, 35 U.S.C. §§ 154, 173, after which competitors are free to use the innovation.”); *Bonito Boats*, 489 U.S. at 146 (“From their inception, the federal patent laws have embodied a careful balance between the need to promote innovation and the recognition that imitation and refinement through imitation are both necessary to invention itself and the very lifeblood of a competitive economy.”).

²⁰⁸ *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 481 (1974) (“The maintenance of standards of commercial ethics and the encouragement of invention are the broadly stated policies behind trade secret law.”). The Supreme Court has long recognized that, with respect to innovations not eligible for patent protection, “[t]rade secret law will encourage invention in areas where patent law does not reach, and will prompt the independent innovator to proceed with the discovery and exploitation of his invention. Competition is fostered and the public is not deprived of the use of valuable, if not quite patentable, invention.” *Id.* at 485. The *Kewanee Oil* Court also acknowledged “the importance of trade secret protection to the subsidization of research and development and to increased economic efficiency within large companies through the dispersion of responsibilities for creative developments.” *Id.* at 482 (citing *Wexler v. Greenberg*, 160 A.2d 430, 434-35 (Pa. 1960)); see also RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 cmt. a (“[T]he protection of trade secrets has been justified as a means to encourage investment in research by providing an opportunity to capture the returns from successful innovations.”). Not surprisingly, commentators have had their disagreements on the justifications of trade secret protections. See, e.g., Michael Abramowicz & John F. Duffy, *Intellectual Property for Market Experimentation*, 83 N.Y.U. L. REV. 337, 391 (2008) (asserting that “the goal of trade secret law is not to encourage the production of . . . information so much as the production of . . . business”); Mark Lemley, *The Surprising Virtues of Treating Trade Secrets as IP Rights*, 61 STAN. L. REV. 311, 314 (2008) (“Understanding trade secrets . . . as imposing a consistent set of standards on claims that would otherwise be based on disparate legal theories and claims of entitlement or free riding—advances the goals of innovation and promotes responsible business conduct without limiting the vigorous competition on which a market economy is based.”); Michael Risch, *Why Do We Have Trade Secrets?*, 11 MARQ. INTELL. PROP. L. REV. 1, 26 (2007) (“[C]reating incentives to innovate is a very minor justification of trade secret law.”).

²⁰⁹ See, e.g., *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1002-04 (1984); *Philip Morris, Inc. v. Reilly*, 312 F.3d 24, 46 (1st Cir. 2002) (en banc) (holding that state regulation requiring disclosure of the content of cigarettes was a taking of trade secrets); *E. I. du Pont de Nemours & Co. v. United States*, 288 F.2d 904, 912 (Ct. Cl. 1961) (upholding takings claim); *DVD Copy Control Ass’n v. Bunner*, 75 P.3d 1, 14 (Cal. 2003) (holding that trade secrets represent a “constitutionally recognized property interest in [information]”); 1 ROGER M. MILGRIM & ERIC E. BENSON, *MILGRIM ON TRADE*

prohibits the unauthorized use or disclosure of trade secrets by private parties; indeed, most states have statutes on the misappropriation of trade secrets.²¹⁰

Tracking the goals of intellectual property laws, the current tax regime governing patents and patent-like property was designed, although not optimally, to promote innovation through various tax incentives (i.e., a research tax credit, a current deduction for research expenditures, and reduced capital-gains tax on patent assignments).²¹¹ The more complex question, however, is the extent to which tax laws should encourage other intellectual property activities. At first glance, it is arguable that the current tax regime does not adequately promote the goals of other types of intellectual property, such as copyrights and trademarks—that it actually hinders those goals. A closer look, however, reveals that most, if not all, intellectual property rights (not just patents) achieve the same objectives: innovation and/or efficiency. Patent and copyright laws in general—and, to a lesser extent, trade secret laws—focus on innovation.²¹² Trademark laws target efficiency in the marketplace for both the producer and consumer of a trademarked product or service.²¹³ Given these similar objectives, the disparate tax treatment of different types of intellectual property is hard to justify.

The U.S. Constitution empowers Congress to promote the progress of *both* science and the useful arts, and as a consequence, Congress has granted significant protections for *both* patents and copyrights with “all that means for the social and economic benefits.”²¹⁴ The intellectual property system encourages innovation by rewarding *both* inventors and authors with exclusive rights in their inventions and works of authorship for a limited time.²¹⁵ Patentees and copyright owners

SECRETS § 2.01[2], at 21 (2010) (“Practically all jurisdictions have recognized that a trade secret is property,” at least in certain senses.).

²¹⁰ See David S. Almeling, *Four Reasons to Enact a Federal Trade Secrets Act*, 19 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 769, 772-75 (2009) (discussing state statutes on trade secrets).

²¹¹ See *supra* notes 130-47, 151-54 and accompanying text.

²¹² See *infra* notes 214-19 and accompanying text.

²¹³ See *infra* notes 225-26 and accompanying text.

²¹⁴ *Diamond v. Chakrabarty*, 447 U.S. 303, 315 (1980) (“The subject-matter provisions of the patent law have been cast in broad terms to fulfill the constitutional and statutory goal of promoting ‘the Progress of Science and the useful Arts’ with all that means for the social and economic benefits envisioned by Jefferson.”).

²¹⁵ *Shaw v. Cooper*, 32 U.S. (7 Pet.) 292, 320 (1833) (“The patent law was designed for the public benefit, as well as for the benefit of inventors. For a valuable

can exploit their intellectual property rights for economic gain.²¹⁶ The public benefits greatly from the innovations, as more inventors and authors create more programs and technologies that transform every industry, from biotechnology to communications and entertainment.²¹⁷ Furthermore, even after a patent or copyright expires, the patent or copyright becomes part of the public domain; at that point, the public is free to use the knowledge embodied in the expired patent or to copy and distribute the works.²¹⁸ With these similarities in goals and substantive protections,²¹⁹ one would expect the tax system to treat patents and copyrights similarly. This has never been the case.

Although substantive copyright laws serve to encourage creative genius and the release of the products of creative genius to the public, the current tax system is not aligned with this objective. A tax credit, while available for patent development costs, does not exist for copyright creation expenditures.²²⁰ Tax deduction rules do not adequately incentivize creation activities, generally requiring the capitalization of copyright creation costs.²²¹ Moreover, tax rules governing copyright assignments are quite harsh. Indeed, since 1950, Congress has prevented individual copyright creators from receiving capital-gains treatment upon the sales of their copyrights.²²² Conversely, patent developers were not covered by

invention, the public, on the inventor's complying with certain conditions, give him, for a limited period, the profits arising from the sale of the thing invented. This holds out an inducement for the exercise of [genius] and skill in making discoveries which may be useful to society, and profitable to the discoverer."); *see also* *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989); *Sears, Roebuck & Co. v. Stiffel Co.*, 376 U.S. 225, 229 (1964).

²¹⁶ *Harper & Row, Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 558 (1985) ("By establishing a marketable right to the use of one's expression, copyright supplies the economic incentive to create and disseminate ideas.").

²¹⁷ *Mazer v. Stein*, 347 U.S. 201, 219 (1954) ("The economic philosophy behind the clause empowering Congress to grant patents and copyrights is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors and inventors in 'Science and useful Arts.'").

²¹⁸ *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975) ("The immediate effect of our copyright law is to secure a fair return for an 'author's' creative labor. But the ultimate aim is, by this incentive, to stimulate [the creation of useful works] for the general public good.").

²¹⁹ *See supra* notes 35-47 and accompanying text.

²²⁰ The research tax credit applies only to expenses incurred in the experimental or laboratory sense, and it does not apply to research conducted in the "social sciences, arts, or humanities." I.R.C. § 41(d) (2006).

²²¹ *See supra* note 63 and accompanying text.

²²² Revenue Act of 1950, ch. 994, § 210, 64 Stat. 906, 932-33 (codified as amended at I.R.C. § 1221(a)(3) (2006)).

the 1950 legislation and, to this day, may be eligible for capital-gains treatment upon the sales of their patents.²²³ Finally, although all intellectual property donors now receive an initial charitable deduction equal to the donor's tax basis, between 1969 and 2004, patent donors (but not copyright donors) received an initial deduction equal to the property's fair market value at the time of contribution.²²⁴ An appropriate legal framework for intellectual property taxation would consider harmonization between the copyright system and the tax system.

In contrast to patent and copyright laws, the goal of trademark law is not to reward innovations of products or services,²²⁵ but rather, to facilitate efficiency.²²⁶ Ironically, however, the tax rules governing trademarks and trade names were not designed with these efficiency goals in mind. Capitalized trademark and trade name costs were not depreciable or amortizable at all prior to 1956, nor between 1986 and 1993. During these periods, they could only be recovered upon the abandonment or sale of the mark or name, reflecting a government doubt that investment in trademark and trade names produced social benefits that market forces might adequately reflect.²²⁷ The capitalized costs of patents, however, have always been eligible for depreciation allowances.²²⁸ As another example, Congress enacted a special provision in 1969 mandating ordinary income treatment on contingent payments received in a trademark or trade name transfer, regardless of whether the transfer is, in substance, a

²²³ I.R.C. § 1235 (2006).

²²⁴ Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a), 83 Stat. 487, 549 (current version at I.R.C. § 170 (2006)) (targeting self-created copyrights but not self-developed patents). In 2004, Congress amended the charitable deduction provision by eliminating the fair market value standard for contributions of most all forms of intellectual property, and reducing the initial amount a donor may deduct. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 882, 118 Stat. 1418, 1627 (codified as amended in I.R.C. §§ 170(e)(1)(B)(iii), 170(m), 6050L (2006)).

²²⁵ See *supra* note 52 and accompanying text.

²²⁶ See *supra* notes 53-56 and accompanying text.

²²⁷ See S. REP. NO. 99-313 (1986) (Comm. Rep.). With the enactment of Section 197 in 1993, capitalized trademark and trade name costs became amortizable ratably over a fifteen-year period. I.R.C. §§ 197(a), (c)(1)(B) (2006).

²²⁸ An early Treasury regulation provided that if an acquired intangible asset could be shown to have a limited useful life, then the capitalized acquisition costs were recoverable over that asset's useful lifetime. Treas. Reg. § 1.167(a)-3 (as amended in 2004). Under this rule, patents were eligible for depreciation due to the fact that they have limited useful lives (twenty years). See 35 U.S.C. §§ 154(a)(2), (d).

sale or a license.²²⁹ For patent transfers, in contrast, the nature of the payments (contingent or noncontingent) is irrelevant in determining tax consequences.²³⁰

An appropriate legal framework for tax legislation governing intellectual property rights should consider the extent to which the tax system is harmonious with the intellectual property goals identified above. Admittedly, maintaining harmony with intellectual property goals can be challenging in a rapidly changing technology and business environment. For instance, special tax incentives for innovative developments were enacted more than fifty years ago.²³¹ Since then, there has been a major shift in the innovation market towards a segmentation model.²³² Desirable transfers of innovation between both segments can be either supported or hindered by the income tax system. An appropriate framework might consider the commercial and business realities of innovation segmentation, and suggest that tax incentives encouraging greater research activity and supporting economic growth should not be limited to the innovation development market alone. The result might be more favorable tax rules governing assignments to private market acquirers and governing donations to research universities—rules that achieve optimal innovation outcomes and enhance economic growth.

Another contemporary phenomenon has been the change in the use of patents in business strategy. In recent years, businesses have looked to patent acquisition for licensing purposes or offensive-use purposes (e.g., to threaten

²²⁹ I.R.C. § 1253(c) (2006).

²³⁰ Early on, the government and courts struggled with the issue of whether a patent assignment should be denied capital-gains treatment solely because the purchase price took the form of contingent payments. Some courts held that the receipt of contingent payments did not prevent a transfer from being considered a sale. *See, e.g., Comm'r v. Celanese Corp. of Am.*, 140 F.2d 339 (D.C. Cir. 1944) (consideration in the form of future royalties); *Comm'r v. Hopkinson*, 126 F.2d 406 (2d Cir. 1942) (same). Others held the receipt of contingent payments did preclude sale treatment. *See, e.g., Bloch v. United States*, 200 F.2d 63 (2d Cir. 1952) (consideration in the form of future royalties). In 1958, the Service issued an administrative pronouncement, ruling that patent transferors could enjoy “sale” treatment (and, hence, capital-gains treatment) even though consideration received is measured by production, use, or sale of the patented article. Rev. Rul. 58-353, 1958-2 C.B. 408.

²³¹ Sections 174 (deduction for limited research and experimental expenditures) and 1235 (safe harbor providing capital-gains treatment for limited assignments of patents) were enacted in 1954, while Section 41 (tax credit for limited research expenditures) was enacted much later in 1981. I.R.C. §§ 41, 174, 1235 (2006).

²³² *See supra* notes 148-49 and accompanying text.

other companies with litigation), as opposed to manufacturing purposes. An appropriate framework would consider the extent to which the tax system should support or discourage this paradigm shift. The current tax system treats all innovation acquisitions alike.²³³ But the innovation goals behind patent rights are tied to the strategic reasons for their acquisition. In particular, patent acquisition for offensive-use purposes frustrates innovation.²³⁴ To promote scientific progress and other innovation goals, then, perhaps the tax system should support the licensing model and not the offensive-use model.

B. Establishing a Rational Basis for Coherent Tax Distinctions Among Intellectual Property Rights

Inequities and administrative inefficiencies in the intellectual property tax system result largely from the modeling of tax distinctions on intellectual property law labels. In many cases, special tax rules governing intellectual property adopt an asset-specific approach, applying to one or more specific types of intellectual property and specifically defined for tax purposes. For example, Section 1235 of the Code applies only to transfers of patents as specifically defined for tax purposes;²³⁵ Section 1221(b)(3) applies only to transfers of copyrights in musical works;²³⁶ and Section 1253 applies to transfers of trademarks and trade names, each of which is specifically defined for tax purposes.²³⁷

Some Code provisions make no tax distinctions among the different types of intellectual property. These provisions adopt a “grouping approach,” attempting to affect a larger

²³³ See *supra* note 195.

²³⁴ See *supra* note 160 and accompanying text.

²³⁵ I.R.C. § 1235(a) (2006) (guaranteeing capital-gains treatment for any transfer of all substantial rights to a patent by a statutorily defined holder to an unrelated party); Treas. Reg. § 1.1235-2(a) (as amended in 1980) (providing definition of patent for purposes of Section 1235).

²³⁶ I.R.C. § 1221(b)(3) (2006) (providing that, at the election of a taxpayer, the Section 1221(a)(1) and (a)(3) exclusions from capital asset status do not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in Section 1221(a)(3)).

²³⁷ *Id.* § 1253(a) (requiring ordinary income treatment on *contingent* payments received for the transfer of a trademark or trade name, and requiring ordinary income treatment on *noncontingent* payments received for the transfer of a trademark or trade name if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the mark or name). The terms trademark and trade name were broadly defined in regulations that were proposed in 1971, but eventually withdrawn due to a sunset provision. Prop. Treas. Reg. § 1.1253-1 to -3, 36 Fed. Reg. 13148 (July 15, 1971), *withdrawn*, 58 Fed. Reg. 25587 (Apr. 27, 1993).

group of intellectual property assets by listing the various types of intellectual property assets within the scope of the provisions. Section 170—which contains a special charitable tax deduction provision applicable to intellectual property—takes a true “grouping” approach, applying to “any patent, copyright . . . , trademark, trade name, trade secret, know-how, software . . . , or *similar property*, or applications or registrations of such property.”²³⁸ Section 197—which imposes a mandatory fifteen-year amortization schedule for certain capitalized costs—does the same, applying to “any patent, copyright, formula, process, design, pattern, knowhow, format, or *other similar item*,” and “any trademark or trade name.”²³⁹ Interestingly, these provisions adopting a grouping approach avoid using the broader term “intellectual property.”²⁴⁰

1. Deciding Whether the Tax System Should Adopt Tax Distinctions

Drafters of any tax legislation must consider the scope of the particular provision. Thus, a legal framework for intellectual property taxation should consider whether to adopt tax distinctions for intellectual property areas. A risk of adopting tax distinctions among different types of intellectual property is that the tax system may not be flexible enough to be applied to future innovations and changes in intellectual property.

Internet domain names are a prime example of an intellectual property movement that has outstripped the present tax system. Under the current regime, specific tax rules do not exist for domain names, which are valuable assets that emerged with the arrival of global e-commerce transactions on the Internet.²⁴¹ Are domain names merely variations of traditional forms of intellectual property and other intangible rights to which the existing tax regime can be applied? As the authors have previously argued, domain names that function as source identifiers might be treated under the

²³⁸ I.R.C. § 170(e)(1)(B)(iii) (2006) (emphasis added).

²³⁹ *Id.* §§ 197(d)(1)(C)(iii), (d)(1)(F) (emphasis added).

²⁴⁰ The term “intellectual property” was first mentioned in *Davoll v. Brown*, 1 Woodb. & M. 53, 7 F. Cas. 197, 199 (C.C.D. Mass. 1845). Peter S. Menell, *Intellectual Property and the Property Rights Movement*, 30 REGULATION 36, 37 (2007), available at <http://www.cato.org/pubs/regulation/regv30n3/v30n3-6.pdf>.

²⁴¹ See, e.g., *Domain Name Prices Rise Again*, INVESTOR'S BUS. DAILY, Dec. 29, 2003, at A02.

current tax rules applicable to trademarks, but generic domain names possess “inherent” goodwill unaddressed by the existing tax regime.²⁴²

Another example of the administrative difficulties of an inflexible tax system with distinct rules for different types of intellectual property is what we identify as the “Coca-Cola” problem. In business practice today, many different types of intellectual property are often bundled together, as many forms of intellectual property protection are available for a particular product or service.²⁴³ This bundling phenomenon raises the question: How should a particular transaction involving bundled intellectual property assets be treated for tax purposes under an asset-specific tax regime that maintains distinct rules for different types of intellectual property?

There are a “bundle” of intellectual property rights embodied inside and outside each Coca-Cola can or bottle. The *trademark* Coca-Cola was worth about \$68.734 billion in 2009.²⁴⁴ It is not any ordinary trademark; it is a brand with a large equity built through years of advertisements, distributions, and uses in commerce worldwide.²⁴⁵ Coca-Cola created goodwill in the trademark over the years that is attached and associated with that trademark.²⁴⁶

²⁴² Xuan-Thao N. Nguyen & Jeffrey A. Maine, *Taxing the New Intellectual Property Right*, 56 HASTINGS L.J. 1 (2004) [hereinafter Nguyen & Maine, *Taxing the New IP Right*].

²⁴³ Additionally, companies often bundle different types of intellectual property assets when they license in or out for the daily business operation. *See generally* Xuan-Thao N. Nguyen, *Bankrupting Trademarks*, 37 U.C. DAVIS L. REV. 1267, 1309-10 (2004) (observing the bundling of trademarks and other intellectual property assets in licensing practices); Gideon Parchomovsky & Peter Siegelman, *Towards an Integrated Theory of Intellectual Property*, 88 VA. L. REV. 1455 (2002) (noting the integration and simultaneous use of patents and trademarks in business practice and calling for a new theory of intellectual property to address the integration of different types of intellectual property).

²⁴⁴ *Best Global Brands 2009*, INTERBRAND, <http://www.interbrand.com/en/best-global-brands/best-global-brands-2008/best-global-brands-2009.aspx> (last visited Sept. 13, 2010).

²⁴⁵ Brand equity has been equated with the concept of goodwill, which has been defined as “that which makes tomorrow’s business more than an accident. It is the reasonable expectation of future patronage based on past satisfactory dealings . . . [that] gives [the business] a selling value above that of its leasehold, equipment and stock.” EDWARD S. ROGERS, *GOOD WILL, TRADE-MARKS AND UNFAIR TRADING* 13 (1914).

²⁴⁶ *See Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 555-56 (1993) (“Although the definition of goodwill has taken different forms over the years, the shorthand description of goodwill as ‘the expectancy of continued patronage,’ provides a useful label with which to identify the total of all the imponderable qualities that attract customers to the business.” (quoting *Boe v. Comm’r*, 307 F.2d 339, 343 (9th Cir. 1962)) (internal citation omitted)).

The Coke bottle has a unique shape that deserves *trade dress* protection.²⁴⁷ Indeed, courts have mentioned the Coke bottle as an example of trade dress worthy of legal protection.²⁴⁸ Trade dress protection extends to the product's packaging, and its overall look and feel that serve as a source identifier in the eyes of the consumer.²⁴⁹ Protected trade dress enjoys a similar protection available to trademarks under federal and state laws.²⁵⁰ The distinctive red and white design on the Coke tin can is easily recognizable today. The consumer walking down a beverage aisle has no difficulty distinguishing a pack of Coke cans from the others.²⁵¹ This design is protected under trademark law.²⁵²

²⁴⁷ See Gary Myers, *Statutory Interpretation, Property Rights, and Boundaries: The Nature and Limits of Protection in Trademark Dilution, Trade Dress, and Product Configuration Cases*, 23 COLUM.-VLA J.L. & ARTS 241, 260 (2000) (“[N]ot only is the name Coca-Cola protectable, but so is the red-and-white swirl packaging of its producer’s cans and the distinctive shape of the old-fashioned Coke bottle.”).

²⁴⁸ E.g., *Wal-Mart Stores, Inc. v. Samara Bros.*, 529 U.S. 205, 215 (2000) (“[A] classic glass Coca Cola bottle, for instance, may constitute packaging for those consumers who drink the Coke and then discard the bottle, but may constitute the product itself for those consumers who are bottle collectors, or part of the product itself for those consumers who buy Coke in the classic glass bottle, rather than a can, because they think it more stylish to drink from the former.”).

²⁴⁹ See *Traffix Devices, Inc. v. Mktg. Displays, Inc.*, 532 U.S. 23, 28 (2001) (“It is well established that trade dress can be protected under federal law. The design or packaging of a product may acquire a distinctiveness which serves to identify the product with its manufacturer or source; and a design or package which acquires this secondary meaning, assuming other requisites are met, is a trade dress which may not be used in a manner likely to cause confusion as to the origin, sponsorship, or approval of the goods.”); *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 775-76 (1992) (providing trade dress protection for the look and feel of a fast food restaurant); see also 15 U.S.C. § 1125(a)(3) (2006) (“In a civil action for trade dress infringement under this chapter for trade dress not registered on the principal register, the person who asserts trade dress protection has the burden of proving that the matter sought to be protected is not functional.”).

²⁵⁰ See *Moseley v. V Secret Catalogue, Inc.*, 537 U.S. 418, 428 (2003) (stating that federal unfair competition law “broadly prohibits uses of trademarks, trade names, and trade dress that are likely to cause confusion about the source of a product or service”), *superseded by statute*, Trademark Dilution Revision Act of 2006 § 2, 15 U.S.C. § 1125(c)(1) (2006); *Wal-Mart*, 529 U.S. at 209 (observing that the federal Lanham Act extends protections to “word marks, such as ‘Nike,’ and symbol marks, such as Nike’s ‘swoosh’ symbol, but also ‘trade dress’—a category that originally included only the packaging, or ‘dressing,’ of a product . . . [and] the design of a product”); see also *Astoria Indus. of Iowa, Inc. v. Brand FX Body Co.*, No. 2-08-144-CV, 2010 WL 1433404, at *7-8 (Tex. App. Apr. 8, 2010) (holding that Texas unfair competition law against misappropriation of non-functional trade dress design is not preempted by federal patent law and affirming the trial court’s decision in favor of the plaintiff on the state claim of unfair competition against misappropriation).

²⁵¹ Dana M. Herberholz, *Curing Confusion: An Overview of the Regulatory Complexities of Obtaining Pharmaceutical Trademarks and Prescription for Reform*, 8 MINN. J.L. SCI. & TECH. 97, 100 (2007) (“The protections of trademark law enable the supermarket customer to choose to purchase COCA-COLA® to the exclusion of other

The Coke formula is a well-kept *trade secret* that ensures the success of the beverage.²⁵³ Others have tried to imitate the brown-colored drink but could not. Other brown drinks are sold under trademarks, such as Pepsi-Cola and Dr. Pepper, but none approaches the unique taste of Coke.²⁵⁴ There is no doubt that the trade secret of the Coke formula is very valuable.²⁵⁵

A legal framework for intellectual property taxation should consider the most efficient manner to reflect the evolution of intellectual property rights and the realities of a changing economy. Consider a transaction involving the bundling of intellectual property rights embodied inside and outside each Coca-Cola can or bottle. A tax system that groups together various intellectual property rights for tax purposes might be more easily applied in practice than a system that adopts separate tax rules for separate transactions involving differing types of intellectual property. The grouping approach would avoid questions over whether the tax results should be dictated by focusing on the trademark Coca-Cola, on the trade dress of the Coke can, or on the trade secret of the Coke formula. When focused on all three of these rights as one unified asset, a grouping approach would also eliminate messy allocation and valuation issues.

The current tax system adopts a grouping approach for many acquisitions of intellectual property (i.e., intellectual

colas, knowing that the famous red label showcasing white letters refers to a particular and familiar brand of cola.”).

²⁵² See *Coca-Cola Co. v. Gemini Rising, Inc.*, 346 F. Supp. 1183, 1183 (E.D.N.Y. 1972) (granting Coca-Cola’s motion to enjoin defendant from using Coca-Cola’s red sign and white script to sell posters saying, “Enjoy Cocaine”).

²⁵³ See *Coca-Cola Bottling Co. of Shreveport v. Coca-Cola Co.*, 107 F.R.D. 288, 286 (D. Del. 1985) (finding that the Coca-Cola formula is “one of the best-kept trade secrets in the world” and that it is kept locked away in an Atlanta bank vault which may “only be opened upon a resolution from the Company’s Board of Directors”).

²⁵⁴ See, e.g., *United States v. Williams*, 526 F.3d 1312, 1323-24 (11th Cir. 2008) (upholding conspiracy convictions for defendants who attempted to sell Coca-Cola’s formula to Pepsi, noting the severity of harm that Coca-Cola could have suffered if defendants had been successful).

²⁵⁵ See *id.*; *Coca-Cola Co. v. Reed Indus., Inc.*, 864 F.2d 150 (Table), 1988 WL 124469, at *1 (Fed. Cir. 1988) (affirming the district court’s injunction against the defendants in a case brought by Coca-Cola for misappropriation of its Coke formulas); *Xpel Techs. Corp. v. Am. Filter Film Distribs.*, No. SA-08-CA-175-XR, 2008 WL 3540345, at *5 (W.D. Tex. Aug. 11, 2008) (“Take for example the formula for making Coca-Cola. This formula is a trade secret possessed by The Coca-Cola Company. If a competitor surreptitiously eavesdropped on an internal conversation in which Coke employees were discussing this formula, and if this competitor then started using the improperly acquired formula in the making of its products, Coca-Cola would justifiably be upset.”).

property acquired as part of the acquisition of assets constituting the acquisition of a trade or business). Section 197, which was enacted in 1993 to simplify tax depreciation rules for intangible property, adopts a single depreciation method—a straight-line method—and a single, fifteen-year recovery period for the capitalized costs of acquiring many forms of intellectual property.²⁵⁶ Thus, a purchaser of the bundle of intellectual property rights embodied in the Coca-Cola product (trademark, trade dress, and trade secret rights) would amortize the total purchase price ratably over fifteen years.

In contrast to its treatment of intellectual property acquisitions, the tax regime does not adopt a grouping approach for the sale of intellectual property. Instead, the Code contains special tax rules for the assignment of trademarks,²⁵⁷ and it relies on general tax rules for the assignment of trade secrets and trade dress rights.²⁵⁸ Thus, the seller of a bundle of intellectual property rights embodied in the Coca-Cola product would be required to allocate the sales price among the various intellectual property rights and apply different tax rules to each in order to determine the tax results.²⁵⁹ This would not be an easy task in light of the bundling of the various intellectual property rights.

The bundling problem, as highlighted in the Coca-Cola example above, also arises in the context of billboards. Each billboard—advertising, for example, Nike products, Marlboro cigarettes, or Wrigley gum—is a copyrighted work of authorship.²⁶⁰ The creators express their ideas in a tangible medium that conveys a message embedded in the depiction. The author of a billboard may be a freelance artist or an

²⁵⁶ I.R.C. § 197 (2006). See TECHNICAL EXPLANATION, *supra* note 166, at 147 (explaining that Congress created Section 197 to streamline federal taxation of intangible assets).

²⁵⁷ I.R.C. § 1253 (2006).

²⁵⁸ *Id.* §§ 1221, 1222, 1231.

²⁵⁹ Gain from the sale of the trademark would be ordinary income if payments were contingent on the productivity, use, or disposition of the mark, or if payments were noncontingent and the transferor retained any significant power, right or continuing interest with respect to the subject matter of the mark. *Id.* § 1253(a)-(c). In contrast, gain from the sale of the trade secret most likely would be treated as capital gain under general capital-gains provisions. *Id.* §§ 1221, 1222, 1231.

²⁶⁰ See *Kleier Adver., Inc. v. Premier Pontiac, Inc.*, 921 F.2d 1036, 1038 (10th Cir. 1990) (involving copyright infringement brought by an advertising company against an automobile dealership and advertising agency for the allegedly infringing use of the copyrighted billboard).

employee of an advertising agency.²⁶¹ The contractual agreements between the product company and the author set forth the identity of the copyright owner.²⁶² The billboard and its associated costs contribute to the building of the recognition, reputation, and goodwill embodied in the trademark or trade dress of each featured product. This bundling of intellectual rights in billboards raises interesting questions. For instance, how should billboard development costs be treated for tax purposes? Should costs be viewed as copyright development costs? Should such costs be treated as part of the development of a trademark or trade dress? Or should costs be treated as general advertising expenditures? The tax results under the current system depend on the answers to these questions.²⁶³ A more efficient regime would produce similar results regardless.

Another classic example of the bundling of rights is computer software. For instance, Microsoft Windows is a group of complex software programs covered by many copyrights.²⁶⁴ Each time a newer version of the software is created, there is a potential new copyright.²⁶⁵ Additionally, certain functions for

²⁶¹ *Id.* In *Kleier Advertising*, the author of the copyrighted billboard “Beat the Pants” advertisement program was an advertisement agency with many employees and the billboard program “has been a traffic-stopping success in forty geographical markets throughout the United States and Canada.” *Id.*

²⁶² *Id.* (noting that if a company wants to use the “Beat the Pants” billboard ad, it must obtain a license from the advertisement agency).

²⁶³ Under the current intellectual property taxation regime, copyright development costs incurred by a corporation are not currently deductible, but must be capitalized. I.R.C. §§ 263(a), 263A(a)-(b) (2006); Treas. Reg. §§ 1.263(a)-4(b)(1)(ii)-(iii), -4(d) (2004). The costs of building up the goodwill value in a trademark are generally treated as deductible advertising costs, see Rev. Rul. 92-80, 1992-2 C.B. 57, but fees paid to the Trademark Office for trademark protection are not currently deductible, Treas. Reg. § 1.263(a)-4(l), ex. 9(i) (2004). The actual costs of building the tangible property (the physical billboard itself), are not deductible but must be capitalized. Rev. Rul. 92-80, 1992-2 C.B. 57.

²⁶⁴ See *Microsoft Corp. v. Liu*, No. 1:06-CV-1352-JOF, 2007 WL 4125753, at *3 (N.D. Ga. Oct. 31, 2007) (listing the certificates of copyright registrations for some of Microsoft Windows software programs, including (1) TX 4-905-936 (“Office 2000 Pro”); (2) TX 4-905-950 (“Access 2000”); (3) TX 4-905-949 (“Excel 2000”); (4) TX 4-906-019 (“Outlook 2000”); (5) TX 4-905-952 (“PowerPoint 2000”); (6) TX 4-905-951 (“Word 2000”); (7) TX 4-905-937 (“Publisher 2000”); (8) TX 4-309-301 (“FrontPage 2000”); and (9) TX 4-899-117 (“PhotoDraw 2000”).

²⁶⁵ See *Dispatch Automation, Inc. v. Richards*, 280 F.3d 1116, 1120 (7th Cir. 2002) (noting that software developers do not register numerous versions of the software as new versions are continually being created) (“One might wonder why, if the code for RiMS 2000 is as different from the code for its predecessors as Dispatch Automation claims, neither Dispatch Automation nor Richards has registered it with the Copyright Office. Asked this question at his deposition, Richards answered that if you tried to submit a copyright application every time there was a new version of the program you would spend all your time trying to continually recopyright the program since . . . the program changed literally hundreds of times that day.”).

Windows software programs are covered by patents.²⁶⁶ Moreover, there is proprietary information and know-how embodied in Windows that is protected by trade secret law.²⁶⁷ The name “Windows” is a known trademark, identifying the products widely installed in most computers and used by millions.²⁶⁸ The four curving, colorful panels of the Windows logo are also entitled to protection under trademark law.²⁶⁹ An administratively efficient tax system would be equipped to address a transaction involving the complex network of software seen in Windows.

Another example of the “Coca-Cola” bundling problem is video games. In 2008, the revenue for games and supporting systems, software, and accessories reached \$21.33 billion,²⁷⁰ and the number has been projected to increase to \$48.9 billion by 2011.²⁷¹ A recent study revealed that the video-game industry employed 32,000 people in thirty-four states, and in 2009, these employees received \$2.9 billion in compensation.²⁷² Another study reported that the video-game industry is growing faster than other industries and has surpassed the ailing music industry.²⁷³ The creators, publishers, and distributors of video games rely on the bundling of different types of intellectual property for the daily operation of their businesses. For

²⁶⁶ Benjamin J. Kormos, *Giving Frankenstein a Soul: Imposing Patentee Obligations*, 21 INTELL. PROP. J. 309, 341 (2009) (“As of 2007, Microsoft held more than 6,000 software patents.”).

²⁶⁷ Robert W. Gomulkiewicz, *Conditions and Covenants in License Contracts: Tales From a Test of the Artistic License*, 17 TEX. INTELL. PROP. L.J. 335, 338 (2009) (observing that Microsoft and other software companies rely on trade secret protection afforded to software programs distributed in binary form).

²⁶⁸ Microsoft has brought legal actions for using its well-known Windows trademark. See, e.g., *Microsoft Corp. v. Lindows.com, Inc.*, No. C01-2115C, 2002 WL 31499324 (W.D. Wash. Mar. 15, 2002).

²⁶⁹ See *Microsoft Corp. v. Silver Star Micro, Inc.*, No. 1:06-cv-1350-WSD, 2008 WL 115006, at *2 (N.D. Ga. Jan. 9, 2008) (listing the various trademark registrations for Microsoft “flag” logos that were the subject of a successful trademark infringement case).

²⁷⁰ *2008 US Video Game Sales Reached \$21.33 Bln*, IT FACTS (Jan. 15, 2009), <http://www.itfacts.biz/2008-us-video-game-sales-reached-2133-bln/12439>.

²⁷¹ Ralph Baer, *Genesis: How the Home Video Games Industry Began*, http://www.ralphbaer.com/how_video_games.htm (last visited Mar. 16, 2009) (recounting the history of home video games); Georg Szalai, *Video Game Industry Growth Still Strong: Study*, REUTERS (June 21, 2007, 4:41 AM), <http://www.reuters.com/article/idUSN2132172920070623>.

²⁷² STEPHEN E. SICNEK, ENTMT SOFTWARE ASS’N, VIDEO GAMES IN THE 21ST CENTURY 1 (2010), available at http://www.theesa.com/facts/pdfs/VideoGames21stCentury_2010.pdf.

²⁷³ Szalai, *supra* note 271 (“The video game sector will remain one of the above-average growth segments of the global entertainment industries through 2011, with global games spending set to exceed music spending this year.”).

example, game companies seek patent procurements for new game functions and initiate infringement litigation against other game companies for violations involving patent-related video games.²⁷⁴ Likewise, game companies utilize trademark law to protect the goodwill accumulated in video-game names and to enforce the trademarks against unauthorized use of similar or identical games that are likely to cause consumer confusion.²⁷⁵ In addition, game companies may rely on trade dress law to protect the look and feel of their game displays.²⁷⁶ Most often, companies rely on copyright law for the protection of their games and prohibition of infringements.²⁷⁷ In reality, video games are all about software; indeed, the industry terms these games “entertainment software.”²⁷⁸

These four bundling examples in the beverage, advertising, software, and game industries are reminders that companies today rely on many different types of intellectual property. These examples are not the exception; they are the norm. For example, in the biotech or biopharma industry, drug companies rely on patents²⁷⁹ and trade secrets for the protection of their research, development, and invention of certain

²⁷⁴ See, e.g., *Hochstein v. Microsoft Corp.*, No. 04-73071, 2008 WL 4387594 (E.D. Mich. Sept. 24, 2008) (involving a video-game patent titled “Apparatus and Method for Electrically Connecting Remotely Located Video Games,” U.S. Patent No. 5,292,125); *Alpex Computer Corp. v. Nintendo Co.*, 770 F. Supp. 161, 162 (S.D.N.Y. 1991) (noting that the U.S. Patent No. 4,026,555 (the 555 patent) is “a patent that involves the earliest video games”).

²⁷⁵ E.g., *Nintendo of Am., Inc. v. Brown*, 94 F.3d 652 (Table), 1996 WL 468590, at *1 (9th Cir. 1996) (“The record supports the district court’s determination that consumer confusion would occur about the origin of the video games at issue because they were virtually identical to the games sold by Nintendo.”); see also *Sony Computer Entm’t, Inc. v. Connectix Corp.*, 203 F.3d 596 (9th Cir. 2000) (trademark dilution claim in a case involving console video games).

²⁷⁶ See, e.g., *Incredible Techs., Inc. v. Virtual Techs., Inc.*, 400 F.3d 1007 (7th Cir. 2005) (copyright claims in the video game instructions and display, trade dress infringement claims).

²⁷⁷ See, e.g., *Wakefield v. Walt Disney Co.*, 321 F. App’x 685 (9th Cir. 2009) (copyright protection and infringement claims of Kingdom Hearts video games), *cert. denied*, 130 S. Ct. 752 (2009); *Sony Computer Entm’t Am., Inc. v. Bleem, L.L.C.*, 214 F.3d 1022 (9th Cir. 2000) (action alleging that developer’s use of “screen shots” from manufacturer’s games in developer’s advertising violated manufacturer’s copyright); *Nintendo*, 94 F.3d 652 (Table), 1996 WL 468590 (affirming copyright and trademark infringement claims because defendant’s games were identical to plaintiff’s games); *Frybarger v. Int’l Bus. Machs. Corp.*, 812 F.2d 525 (9th Cir. 1987) (analyzing copyright infringement claim between two video games).

²⁷⁸ See *Economic Data*, ENTMT SOFTWARE ASS’N, <http://www.theesa.com/facts/econdata.asp> (last visited Oct. 7, 2010).

²⁷⁹ See generally *Pharmaceutical Patents*, INNOVATION.ORG, http://www.innovation.org/documents/File/Pharmaceutical_Patents.pdf (last visited Sept. 13, 2010).

drugs.²⁸⁰ Drug companies also rely on copyrights, trade dress, and trademarks in their advertising campaigns. To market and sell their drugs, for instance, drug companies use trademarks along with pamphlets and instructions.

As these examples illustrate, the rigidity of the current intellectual property taxation scheme renders it incongruent with the realities of the current intellectual property system. Specifically, it is difficult to analyze the tax results of domain names and other Internet-based intangibles, as well as the tax results of transactions involving integrated intellectual property. Thus, an appropriate legal framework for intellectual property tax rules should ensure adequate flexibility in rules to deal with the evolution of intellectual property and the reality of the changing economy. A tax system flexible enough to account for new intangible rights and emerging intellectual property trends, such as the integration and simultaneous use of intellectual property, would achieve clearer tax results as well as administrative efficiency.

2. Determining a Basis for Tax Distinctions

If the tax system adopts distinctions for different types of intellectual property rights, then, to minimize inequities, a legal framework for tax rules should question whether substantive differences among forms of intellectual property justify different tax results for each form. While all types of intellectual property share certain common characteristics, there are substantive differences among the forms. A patent is issued for 20 years, and a copyright is in force for the life of the author plus 70 years (or 95 years, or in the case of a hired creator, 120 years).²⁸¹ The protection for trademarks or trade names, by contrast, continues for as long as they are used in commerce.²⁸² To what extent, if any, should these and other substantive differences justify different tax results? Under present rules, the receipt of contingent payments in patent and copyright transfers is treated vastly differently from the receipt

²⁸⁰ See, e.g., Shankar Vedantam, *Antidepressant Makers Withhold Data on Children*, WASH. POST, Jan. 29, 2004, at A1.

²⁸¹ See *supra* notes 48-50 and accompanying text.

²⁸² A trademark right is based on use. Abandonment of a trademark occurs when the owner stops using the trademark in commerce. Federal trademark law presumes abandonment after three years of non-use of the trademark. 15 U.S.C. § 1127 (2006). Abandonment of a trademark could occur if the owner failed to police the trademark so that it becomes the generic name for the product or service with which it is used. *Id.*

of contingent payments in trademark and trade name transfers.²⁸³ One commentator has argued that the only major substantive difference among these forms—duration—does not justify differing effects in contingent payments.²⁸⁴ But perhaps there are other substantive differences supporting differing tax results; for example, patents and copyrights further innovation goals, whereas trademarks further efficiency goals. An appropriate legal framework would focus attention on this issue and yield fewer perceived tax inequities.

If tax distinctions are deemed justified based on substantive differences among intellectual property forms, a framework should question whether the different types of intellectual property are treated in an appropriate manner vis-à-vis one another. Assume, for example, that patents and copyrights should be treated as equals for tax purposes due to their substantive similarities (because both serve to promote science and the arts)²⁸⁵ and that, conversely, trademarks should be treated differently for tax purposes (because they serve the different purpose of protecting consumers and trademark owners).²⁸⁶ A legal framework for analyzing intellectual property tax rules would question whether the treatment of patents and copyrights as one group, and trademarks as another, is an appropriate method of achieving true equity.

As an alternative to focusing on the legal attributes of intellectual property and basing tax distinctions upon their substantive differences, a tax framework might base tax distinctions on the purposes that intellectual property assets serve. For example, instead of developing separate rules for identified intangibles (such as patents, trade secrets, copyrights, trademarks, trade names, and computer software), creating legal definitions, and carving out exceptions, a tax system could develop separate rules for “technology-based intangible assets,” “marketing-based intangible assets,” and “artistic-based intangible assets.”²⁸⁷

²⁸³ See *supra* notes 93, 229-30 and accompanying text.

²⁸⁴ See Daniel A. Izzo, *Contingent Payment Transfers of Trademarks: A Sale in License Clothing*, 12 VA. TAX REV. 263, 275-76 (1992).

²⁸⁵ See *supra* notes 31-47 and accompanying text.

²⁸⁶ See *supra* notes 51-56 and accompanying text.

²⁸⁷ With respect to accounting for business combinations, this is the approach that was adopted by the Financial Accounting Standards Board (FASB). See FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 141 (BUSINESS COMBINATIONS) app. F (2007). Technology-based intangibles include, for example, patents, unpatented technology, software, trade secrets, etc. Marketing-based intangibles include

Basing tax distinctions upon intellectual property uses, as opposed to intellectual property definitions, might yield a more flexible tax system capable of handling future innovations and intellectual property movements. As noted above, special tax rules governing intellectual property do not currently address domain names.²⁸⁸ It is arguable that domain names functioning as trademarks be treated as trademarks under current tax rules.²⁸⁹ But under this framework, they might fall within the category of “technology-based intangible assets” and thus might be treated like the other intangible assets in that category, such as patented and unpatented technology, trade secrets, etc. As with domain names, current tax rules do not specifically deal with websites.²⁹⁰ Instead of treating the various components of a website differently based on current tax treatment of software, copyrightable content, and non-copyrightable content, the proposed framework might treat the website as a whole as a “marketing-related intangible asset.” Such an approach might also eliminate problems caused by the bundling of intellectual property in business practice.

A tax system emphasizing intellectual property uses, as opposed to legal attributes, might yield more rational tax distinctions. Currently, for example, trademark and trade secret acquisition costs are treated the same for tax purposes.²⁹¹ However, it might be justifiable to treat a trade secret used as a technology-based intangible asset differently from a trademark used as a marketing based intangible asset. Likewise, it might be justifiable to treat a copyright that is classified as an artistic-related intangible (e.g., a book, play, or musical work) differently from a copyright that classified as a marketing-related intangible asset (e.g., advertising materials).

trademarks, service marks, trade names, brand names, Internet domain names, etc. Artistic-based intangibles include literary works and copyrights, musical works, photography, maps, etc.; *see also* FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 142 (GOODWILL AND OTHER INTANGIBLE ASSETS) (2008).

²⁸⁸ *See generally* Nguyen & Maine, *Taxing the New IP Right*, *supra* note 242.

²⁸⁹ *Id.*

²⁹⁰ Under the current tax rules, taxpayers and advisors are left with questions, such as: Should the costs relating to the development of a website be treated the same as software development costs? How should the costs of creating or purchasing content for websites be treated? Does it make a difference if some website content is copyrightable or non-copyrightable? If websites are considered variations of existing intellectual or intangible property rights to which the existing tax law can be adopted, then the tax treatment of websites might depend on the website's components (e.g., software, copyrightable content, non-copyrightable content). This approach is not easily applied in practice.

²⁹¹ *See supra* note 94 and accompanying text.

This approach would ensure consistency because a copyright on a book (an artistic-related intangible) would necessarily be treated in the same way as a copyright on a musical work (also an artistic-related intangible). Current law does not treat these copyrights similarly.²⁹²

A system focusing on intellectual property uses would also eliminate the debate over whether emphasis should be on protections available or protections actually obtained. Certain property—such as computer software—is eligible for more than one type of intellectual property protection.²⁹³ This circumstance raises the question of whether tax consequences should be affected by the protections available (e.g., patent, copyright, trade secret), or whether tax consequences should depend on the actual protections obtained. Consider the tax treatment of an assignment of computer software or a design patent. Under current tax rules, a capital asset does not include any copyright in the hands of the person who created it.²⁹⁴ An interesting question that arises is whether this copyright exclusion applies when property, such as a design patent or computer software, is both patentable and copyrightable. Under current rules, the copyright exclusion does not apply if “a patent or an invention, or a design . . . may be protected only under the patent law and not under the copyrightable law.”²⁹⁵ As a result, design patents, which are “eligible for both patent and copyright protection,” are subject to the copyright exclusion. Likewise, computer software, which is copyrightable but often protected through a trade secret agreement, is also subject to the copyright

²⁹² See *supra* notes 112-13 and accompanying text.

²⁹³ Copyright law has traditionally served as the source of legal protection for computer programs. See, e.g., *Williams Elecs., Inc. v. Arctic Int'l, Inc.*, 685 F.2d 870, 875 (3d Cir. 1982) (“[T]he copyrightability of computer programs is firmly established after the 1980 amendment to the Copyright Act”); see also 17 U.S.C. § 101 (2006). In addition to copyright law, patent protection has been extended to computer software inventions which are also known as Internet patents or business method patents. See *Bilski v. Kappos*, 130 S. Ct. 3218 (2010) (holding that business method inventions are patentable subject matter under section 101 of the patent statute). In addition to copyright and patent law, trade secret has been extended to protect computer programs. See *MGE UPS Sys., Inc. v. GE Consumer & Indus., Inc.*, No. 08-10521, 2010 WL 3769210, at *8 (5th Cir. 2010) (upholding the district court’s permanent injunction against the defendant for copyright infringement and trade secret misappropriation of the plaintiff’s software).

²⁹⁴ I.R.C. §§ 1221(a)(3)(A), 1231(b)(1)(C) (2006).

²⁹⁵ Treas. Reg. § 1.1221-1(c)(1) (as amended in 1980).

exclusion.²⁹⁶ Basing tax distinctions on intellectual property uses would eliminate this outcome.²⁹⁷

CONCLUSION

Federal tax rules governing intellectual property evolved in the absence of an appropriate legal framework for the intersection of intellectual property and taxation schemes. As a result, the current intellectual property tax regime is flawed on several grounds. Utilizing horizontal equity as a tax policy analysis tool uncovers numerous differences in the tax treatment of similar intellectual property owners, assets, and transactions. Utilizing an appropriate efficiency standard to evaluate tax subsidies for intellectual property (e.g., tax expenditures in the form of deductions and credits) reveals that many of the tax expenditures for intellectual property are circumscribed to have limited effectiveness. Although some aspects of the current tax scheme complement and promote the intellectual property scheme, others hinder it and stifle desirable intellectual property activity. Furthermore, distinctions in the current tax system—different rules for different types of intellectual property—have produced an inflexible scheme not easily applied to evolving intellectual property rights and practices, particularly transactions involving integrated intellectual property.

A rational, coherent legal framework is needed for the development of an intellectual property tax system that does not violate fundamental equity and efficiency principles of tax policy. In developing an appropriate framework for intellectual property tax rules, the following questions should be asked: First, should the taxation and intellectual property schemes be harmonious (i.e., should the tax system be designed to support the intellectual property system)? Second, if tax distinctions among intellectual property are to be adopted, what is the basis for making them?

²⁹⁶ For criticism of the current approach, see CHARLES EDWARD FALK, *TAX PLANNING FOR THE DEVELOPMENT AND LICENSING OF COPYRIGHTS, COMPUTER SOFTWARE, TRADEMARKS AND FRANCHISES*, A-26 to -27 (1997).

²⁹⁷ Interestingly, while the tax treatment of assignments of software and design patents is impacted by intellectual property protections, the tax treatment of developments and acquisitions of software and design patents is not. Costs of software development, for example, are generally treated the same (deductible) regardless of the method of protection available or obtained. See Rev. Proc. 2000-50, 2000-2 C.B. 601. A legal framework emphasizing intellectual property uses would avoid such a distinction in the current tax system.